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ABSTRACT

The eight papers contained in this document focus on those tax provisions most directly affecting families and children. Questions addressed include the following: (1) Since the enactment of the first permanent income tax in 1913, how have tax laws affecting families evolved in response to changes in economic and demographic conditions? (2) Relative to prior years, does the current tax code penalize families with children? (3) At what level of income do families make the greatest use of the child care credit? (4) Will families with incomes below the poverty line continue to be subjected to income tax? (5) Under current law and in the various reform proposals, are married couples penalized relative to single taxpayers? (6) Are single heads of household penalized relative to married couples? (7) Are two-earner couples penalized relative to one-earner families? (8) Are large families treated equitably in relation to smaller families? (9) Will decisions to enter or leave the work force be affected by provisions of current tax reform proposals? (10) How do U.S. tax and income transfer systems compare to those in other countries? (11) Would a new "value added tax" treat all families fairly? An introduction notes that these papers do not include analysis of the Treasury II proposal, and that some of the original reform proposals which are included have been modified: modifications are noted where appropriate. (RH)

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TAX POLICY: HOW DO FAMILIES FARE?

A REPORT

OF THE

SELECT COMMITTEE ON CHILDREN, YOUTH, AND FAMILIES

NINETY-NINTH CONGRESS

FIRST SESSION

OCTOBER 1985

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[1] Papers presented at a conference, "Federal Tax Policy: What's In It For Women and Families", sponsored by the Women's Research and Education Institute in cooperation with the Family Impact Seminar.

INTRODUCTION

The current tax system requires the average American family with children to pay over $7,000 in taxes each year, more than half of which go to federal income taxes.[1] In addition, certain fundamental family matters including family formation, employment, and child care, carry with them important tax considerations as a result of specific tax provisions now in place.

For these reasons, and because tax reform is more than ever under consideration, we believe the tax system should be seriously analyzed from the point of view of its impact on families and the children who live in them. The eight papers included in "Tax Policy: How Do Families Fare", bring us much closer to that goal.

Among the many critical family/tax related questions addressed in these papers are:

Since 1913, when the first permanent income tax was enacted, how have tax laws affecting families evolved in response to changes in economic and demographic conditions? [*Women and Families as Taxpayers: A History* (Rosemary Marcuss and Rosemarie Nielson, CBO)]

Relative to prior years, does the current tax code penalize families with children? *The Tax Treatment of Households of Different Size* (Eugene Steuerle, from "Taxing the Family," American Enterprise Institute for Public Policy Research, 1983)

At what level of income do families make the greatest use of the child care credit? [*Federal Tax Policy and the Family: The Distribution of the Dependent Exemption, The Child and Dependent Care Tax Credit, and the Earned Income Credit by Adjusted Gross Income Class, Tax Year 1982* (Stacey Kean, CRS)]

Will families with incomes below the poverty line continue to be subjected to income tax? [*Tax Reform and the Family* (Geraldine Gerardi and Eugene Steuerle, Department of the Treasury)]

Under current law and in the various reform proposals, are married couples penalized relative to single taxpayers? Are single heads of household penalized relative to married couples? Are two-earner couples penalized relative to one-earner families? [*Family Characteristics and Horizontal Equity: A Comparison of Three Tax Reform Proposals* (Gregg Esenwein, CRS)]

Are large families treated equitably in relation to smaller families? [*Family Characteristics and Horizontal Equity: A*

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[1] In 1983, mean pre-tax income for married couple families with children was $31,841; mean after-tax income was $24,824 (Bureau of the Census).

Comparison of Three Tax Reform Proposals (Gregg Esenwein, CRS)]

Will decisions to enter or leave the work force be affected? [*Implications of Tax Alternatives for Families: How Ten Families Fare Under Five Tax Proposals* (Martha Phillips, Committee on Ways and Means)]

Will changes in the tax treatment of dependent care costs affect all families' ability to meet child care expenses equally? [*Implications of Tax Alternatives for Families: How Ten Families Fare Under Five Tax Proposals* (Martha Phillips, Committee on Ways and Means)]

Beyond the current tax reform debate, how do our tax and income transfer systems compare to those in other countries? [*Financial Help for Vulnerable Families: The Income Transfer Menu* (Alfred Kahn, Columbia University)]

And, finally, would a new "Value added tax" treat all families fairly? [*The Incidence of a Value-Added Tax on the Family* (James Bickley, CRS)]

We would caution against drawing final conclusions regarding the total effectiveness of each reform proposal based on these analyses alone. These papers focus on those tax provisions which most directly affect families and children. The provisions important to families will interact in complex ways with all the other provisions in each proposal, and no conclusions should be drawn without looking at the entire proposal.

Finally, these papers do not include any analysis of the most recent Administration proposal, Treasury II, which appeared subsequent to our request for these papers. Also, some of the reform proposals which are included have since been modified, which we have noted where appropriate.

We are grateful to the Women's Research and Education Institute [WREI] for making available four of the papers that appear here, which were originally presented at a conference, "Federal Tax Policy: What's In It For Women and Families," sponsored by WREI in cooperation with the Family Impact Center. The other three papers were commissioned by the Select Committee on Children, Youth and Families from the Congressional Research Service.

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WOMEN AND FAMILIES AS TAXPAYERS: A HISTORY

Rosemary D. Marcuss and Rosemarie M. Nielsen*

INTRODUCTION

An investigation into changes in the relative status of women and families among major contributors to our federal income tax is well served by a look at the history of the tax. The federal tax code reflects the political process in which the need for revenues forces compromises on social, economic, and administrative issues. Since 1913, the course of the federal income tax has been one of continuing adaptation, slow and incomplete, but adaptation nonetheless.

As contributions of women and families as taxpayers continue to change, so most likely will their official status within the federal tax code; as Benjamin Disraeli said, "Finality is not the language of politics." Future adaptation of the income tax will undoubtedly share some of the characteristics of its antecedents. In this paper we sketch the history of six components of the income tax that have particular, but not unique, application to women and families: the tax rate schedules, the personal exemption, the zero bracket amount (or standard deduction), the dependent care credit, the earned income credit, and provisions addressing divorce.

There have been significant changes in these provisions beginning soon after 1913, when the stage was set for the federal income tax by the ratification of the Sixteenth Amendment. The language of the tax code is now virtually gender-neutral, but this was not always the case. Social attitudes and expectations change slowly. The growing numbers of women working outside the home (particularly mothers of young children) and the increasing incidence of divorce are two of the many manifestations of such change.

What vantage point and what analytical tools best prepare participants for the productive pursuit of better tax compromises? Economists propound three tax policy goals: equity, efficiency, and simplicity.[1] These provide a useful analytic framework for the discussion of tax policy changes, even for those who share the suspicion that the proponents, economists, "exert a minor and scarcely detectable influence on the societies in which they live" (Stigler, 1982, p. 63). These goals are generally accepted as desirable and important, but there is a tension between them that can't be eliminated—as this look into the histories of income tax provisions will reveal.

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* Rosemary Marcuss is Assistant Director, Tax Analysis Division, Congressional Budget Office and Rosemarie Nielsen is an Analyst in the Tax Analysis Division of the Congressional Budget Office. The views expressed in this paper are those of the authors and do not represent the position of the Congressional Budget Office.

[1] Roughly, equity requires that those with equal taxpaying capacities pay equal taxes and those with unequal capacities do not. Efficiency requires that the tax burden not depend on sources or uses of income. Simplicity speaks for itself. It's been called everybody's second choice.

The major elements of the federal personal income tax system that determine tax liability are the definition of income, the allowable deductions and exemptions from income, the tax rates, and the credits allowed against the tax. The three elements most directly affecting the tax treatment of families relative to others—the various tax rate schedules, personal exemptions. and the zero bracket amount (or standard deduction)—are discussed first. Then, three components of the income tax affecting many women—the recognition of child care expenses as costs of earning income, reduced taxes on earned income, and the treatment of divorce—are outlined.

THE TAX RATE SCHEDULES

Marital and family status are only two of a large number of criteria affecting federal income tax liability, but they have the unique distinction of determining which rate schedule the taxpayer faces. There are now four rate schedules: for joint returns and surviving spouses, for heads of households, for single individuals, and for married people filing separate returns—listed here in increasing order of steepness of rates.[2] A head of household is an unmarried person who maintains a home for a child, grandchild, or any other relative who is a dependent.

A tax system primarily must raise sufficient revenue and be generally acceptable to taxpayers. Three income tax principles—progressivity, equal tax burden on taxpayers with equal incomes,[3] and indifference to marital status[4]—affect acceptability, but in changing ways. These goals conflict; movement toward one often entails movement away from another. Further, generally accepted views about what is fair change over time. The history of the income tax code is one of the difficult forging of agreements among legislators faced with competing goals and changing public opinion. This was certainly the case in the changes over time in the basic building blocks of the federal tax system, the definitions of taxpaying units for application of the progressive tax rate schedules.

The four tax rate schedules listed above did not exist when the first permanent federal income tax was enacted in 1913. Indeed, the individual was the only formally recognized taxpaying unit in the federal system until 1948, when the family became the taxpaying unit for most married couples. Over time, finer distinctions among units were made and later realigned. Public discussion, administrative initiatives, legislative responses, and judicial decisions had addressed these issues long before 1913 and will continue to do so as long as there is a need by the government for revenue.

The only taxpaying unit specified in the Income Tax Act of 1913 was the "citizen" or the "person". Only one progressive rate structure was provided. The "individual" was again confirmed to be the only taxpayer in the Revenue Act of 1916. In 1918, married couples were granted the right to file a joint tax return. However, they were required to use the same progressive rate schedule as others, with a combined exemption that was lower than two individual exemptions, making the option undesirable in most cases.

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[2] Steepness of tax rates is a basic, but not the only, determinant of progressivity. Exclusions from income also affect progressivity.

[3] Sometimes referred to as horizontal equity.

[4] Sometimes referred to as marriage neutrality.

THE ALLOCATION OF FAMILY INCOME

In most families resources are shared. In these cases, it's reasonable to consider family income, rather than the separate incomes of the individuals in the family, as a measure of the family's ability to pay taxes. When each spouse was taxed as a separate taxpayer, families with the same combined income had different tax liabilities when their income was divided differently between the spouses (because of the progressive rate structure). In other words, the ability of such families to pay taxes was differentiated with reference only to the income recipient. This resulted in different tax liabilities for some family units with similar combined incomes, which failed to satisfy the principle of equal taxation of equal-income families.[5] This also reduced efficiency in that it created an incentive for spouses to shift income to one another.

In community property states, state law accorded each spouse a legal claim to all family income regardless of source. Families in these states began to divide family income evenly between the spouses for federal income tax purposes to reduce the family's tax liability (again, because of the progressive rate schedule). In other states where spouses did not automatically have a legal claim to family income, legal assignment of family income between spouses could accomplish the same reduction in federal liability. Income from property—rent, dividents, and interest—can always be transferred to another taxpayer if the owner of the income-producing property is willing to give the title to the property to this person. In these other states, the transfer of earned income—wages, salaries, and professional fees—however, required a contractual arrangement.

In 1930, the Supreme Court ruled on the issue of assignment of earned income between spouses in Lucas v. Earl,[6] by forbidding all shifting of such income to another taxpayer, even a spouse, for federal income tax purposes. Families with property income could still shift that income between spouses but now families with only earned income were typically unable to shift income, unless they resided in community property states.[7] The principle that couples with equal incomes should pay the same tax was still not satisfied.

The geographic character of the difference in tax treatment of couples with equal combined incomes was a source of contention from the inception of the tax. As mentioned above, residents of community property states where splitting their income (regardless of source) for tax purposes. Their tax liabilities were lower than those of families with similar incomes from the same sources but living in common law states. (In 1930, there were eight community property states,[8] and forty common law states.) In Poe v. Seaborn [9] (1930), the Supreme Court affirmed the legality of this practice. The Court held that spouses in community property states were, in fact, taxable on one-half of their combined income for federal purposes, nullifying for these taxpayers the prohibition on the assignment of earned income to other taxpayers established in Lucas v. Earl. This ruling confirmed that marriage was determinative of federal taxpaying status, at least for the taxpayers who could reduce their tax liability by splitting earned income. (The government had argued in favor of taxing all community income to the husband on the grounds of his presumed management of and control over it.)

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[5] It can be argued that the actual recipient of the income is the proper taxpaying unit, not the larger family, because (among other reasons) the individual retains ultimate control over the use of the income. In fact, the income of children is treated this way for federal income tax purposes.

[6] 281 U.S. III (1930).

[7] Families operating closely held businesses or family farms could, in effect, share earned income for federal income tax purposes, but most families were not so engaged.

Now, in community property states, a couple's tax liability would be exactly twice that of an unmarried taxpayer with half the couple's total income, and exactly equal to that of other equal-income couples in these states, regardless of the allocation of income between spouses. In common law states, these relationships wouldn't hold because aggregation and splitting of income were not available to married couples. The federal tax system was no longer neutral toward marital status for taxpayers in community property states, because marriage there usually decreased a couple's tax liability. (At that time, the great majority of families had only one earner.) Many common law states considered adopting community property systems to provide the benefits of income splitting to their residents. Some actually did so.

The geographic disparity in tax liabilities was untenable. This, along with the persistent practice of families to reduce their tax liabilities by transferring property between spouses (especially as rates climbed), led the Treasury and later the House Ways and Means Committee (in 1941) to propose mandatory joint filing for husbands and wives living together. Under these proposals, the couple's combined income was to be taxed at the same rates applied to single individuals' incomes. Tax liabilities would rise for couples in community property states and for all couples in which both spouses received income, because aggregation of their incomes (without income splitting) would move then into higher rate brackets. In other words, under the proposed system, marriage would increase the tax liability of all pairs of taxpayers with independent sources of income. The proposal was defeated in the Senate; the income splitting dilemma would require a different resolution at a different time.

The first round in the resolution came when the Revenue Act of 1948 permitted all married couples to aggregate their income and deductions and file a joint return. Their tax liability was set at twice that of a single person with one-half of the couple's income. In other words, the long-established tax practice of couples in community property states of aggregation and income splitting was officially extended to those in common law states. The incentive for do-it-yourself splitting of family investment income via property transfers between spouses was removed. The principle that equal-income couples should be taxed equally was established by accepting the community property assignment of income of both spouses for federal tax purposes. There were now two tax rate schedules, the individual schedule and the joint return schedule with rate brackets twice as wide as the individual schedule bracket. The progressivity of the income tax was reduced. While aggregation and income splitting are often viewed as tax preferences to support families, their enactment was obviously the result of a wide variety of other pressures, legal and administrative as well as social.

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[8] The community property system is a legacy of the Spanish influence in the western United States. Under this system, each spouse has a right to one-half of the couple's joint income, regardless of the source. This implied the principle of equal tax liability for couples with equal income residing in the eight states in which the system was established. All other states had common law systems derived from English law, in which individual property rights prevailed.

[9] 282 U.S. 101 (1930).

The major change in the taxpaying unit in 1948 effectively introduced a type of single penalty, yet the relationship between the tax liabilities (burdens) of single and married taxpayers was hardly discussed at the time. A significant tax reduction was given to couples in common law states. In addition, a type of marriage bonus was introduced: marriage would reduce or leave unaffected the tax liability of individuals regardless of state of residence.

Whatever the origin of the 1948 changes, the tax treatment of unmarried taxpayers supporting dependents was soon considered to be out of line with the special rate schedule made available to married couples. In 1951, a new rate schedule was created for unmarried heads of households supporting dependents, children, or other descendents in their homes. This schedule provided approximately one-half of the advantage of income splitting. Now there were three rate schedules: the head of household, the joint return, and the single taxpayer schedule. The introduction of lower head of household rates seemed to lend credence to the view that the increased cost arising from family responsibility was the politically accepted justification for income splitting by married couples.[10] This argument, however, had not been central to the debate on the 1948 act.

A MARRIAGE PENALTY

The 1948 and 1951 changes made the rate schedule faced by single people seem unjustifiably steep compared to those for married and head of household taxpayers. Middle-bracket single taxpayers bore tax liabilities as much as 42 percent above those of couples with the same combined income. Differentials this high came to be considered unacceptable, even by many who believed that a higher tax rate for single people could be justified on grounds of lower living costs. By the late 1960s, pressure to reduce the single taxpayer rates led to the extension of some of the benefits of income splitting to them in the Revenue Act of 1969. A new lower tax rate schedule was made available to all unmarried taxpayers, which brought their liabilities to within 20 percent of those of married couples with the same combined taxable income. Because all spouses with roughly equal incomes would find the new single taxpayer rates preferable to the joint return rates, married taxpayers filing separate returns were now required to use the old individual taxpayer schedule instead. This was retained as the fourth rate schedule.

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[10] One objection to income splitting has been that the principal beneficiaries, one-earner couples, actually have relatively higher real incomes when the nontaxed services of the spouse working in the home are taken into consideration.

After 1969, the incidence of married two-earner couples increased substantially. These taxpayers now incurred a new marriage penalty: if their combined income was allocated between them more evenly than approximately 80 percent—20 percent, their combined tax liability would be higher than that of two unmarried individuals with the same incomes. In other words, the tax liabilities of these individuals would increase if they married, or decrease if they divorced.[11] Couples with more uneven earnings would get a marriage bonus (a reduction in tax liability), measured relative to two unmarried individuals with like incomes. The penalty or bonus could be substantial. The marriage penalty in 1979 for two-earner couples with an income greater than $80,000 and evenly split between them could exceed $4,600 (Feenberg, 1983, p. 37). As more unmarried two-earner couples chose to establish joint households, these differentials became harder to justify.

In 1981, the Congress enacted a new deduction intended to reduce the disparity in tax treatment between single-earner and two-earner married couples and to reduce the disincentives for potential second-earners to enter the labor force. The deduction is 10 percent of the earnings of the lower-earning spouse up to a maximum deduction of $3,000. The deduction is consistent with the recognition that a nonworking spouse provides the family with income in nonmonetary form and with the belief that the higher costs of earning their income possibly incurred by the two-earner couple should be recognized as a reduction in their ability to pay taxes.

This marriage penalty could have been reduced by giving married couples the option of filing separate returns at lower rates, or by retaining joint filing but adjusting tax rates and reducing progressivity. Separate filing entails some serious complications, such as the need for rules for allocating itemized deductions between spouses. An adjustment of joint-filer rates was precluded in 1981 by the well-established commitment to substantially reduce all tax rates across the board.

The new deduction, like earlier reponses to marriage penalties (and bonuses) is a rough compromise. It is not well focused on those affected by this marriage penalty, and incidentally increases the size and incidence of marriage bonuses. It also fails to eliminate the marriage penalty for most taxpayers. As more married couples earn substantial and similar incomes, pressure to further address this issue may grow.

THE TAXABLE INCOME THRESHOLD

The burden of the income tax on individuals depends on exemptions and deductions as well as on tax rates. One useful measure of tax burden is the effective tax rate, or taxes as a percent of income. The exemptions and the rate schedule jointly determine the progressivity of effective tax rates. The minimum level of income at which federal income tax liability is incurred—the taxable income threshold—is determined for most taxpayers by the sum of allowable personal exemptions and zero bracket amount (or standard deduction). A personal exemption is allowed for each taxpayer and for his or her spouse. Additional exemptions are allowed for each dependent claimed by the taxpayer. For 1985, each exemption is $1,040. The zero bracket amount (ZBA) is, in effect, a deduction given to each taxpayer that varies according to tax filing status. In 1983, about 37 percent of taxpayers itemized their deductions; that is, they had personal deductions in excess of the ZBA. For 1985, the ZBA for single taxpayers and heads of households is $2,390, for married couples filing joint returns, $3,540.[12]

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[11] This type of marriage penalty is the incidental result of any "preference" for single taxpayers.

The personal exemption was introduced back in 1913. The standard deduction (later to become the ZBA) was introduced in 1944 along with significant World War II tax increases. Historically, the personal exemption and the standard deduction often have been used as alternative levers for simplifying the tax code and providing relief from taxation for low-income taxpayers. Therefore, changes in the personal exemption are best described along with coordinated changes in the standard deduction. They are discussed separately here only for organizational ease.

PERSONAL EXEMPTION

The Income Tax Act of 1913 contained a personal exemption of $3,000 for each taxpayer and $1,000 for his or her spouse. A dependent exemption was proposed but dropped. The "normal" tax rate of 1 percent was accompanied by a progressive surtax of 1 to 5 percent. The original very high personal exemption played the role of both the present exemption and the zero bracket amount in establishing the tax-exempt level of income. It was sufficiently large so that only a small portion of citizens owed any tax, which wasn't lost on Senator Henry Cabot Lodge; he called it the "pillage of a class" (Blakey and Blakey, 1940, p. 89). In 1916, the extra $1,000 exemption was extended to "heads of families" (single taxpayers supporting at least one person closely connected to the taxpayer).[13]

A reduction in personal exemptions to $2,000 for couples and heads of families and $1,000 for unmarried individuals in 1917 was part of an effort to raise the revenues needed to finance World War I. At the same time, an exemption of $200 for each dependent was added (see Figure 1). The lower threshold brought many more taxpayers into the system.

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[12] A taxpayer doesn't actually calculate his or her ZBA; it is built into the tax rate schedules—hence the title, zero bracket amount.

[13] The connection was required to be by blood, marriage, or adoption or through legal or moral obligation (Bittker, 1975, p. 1446).

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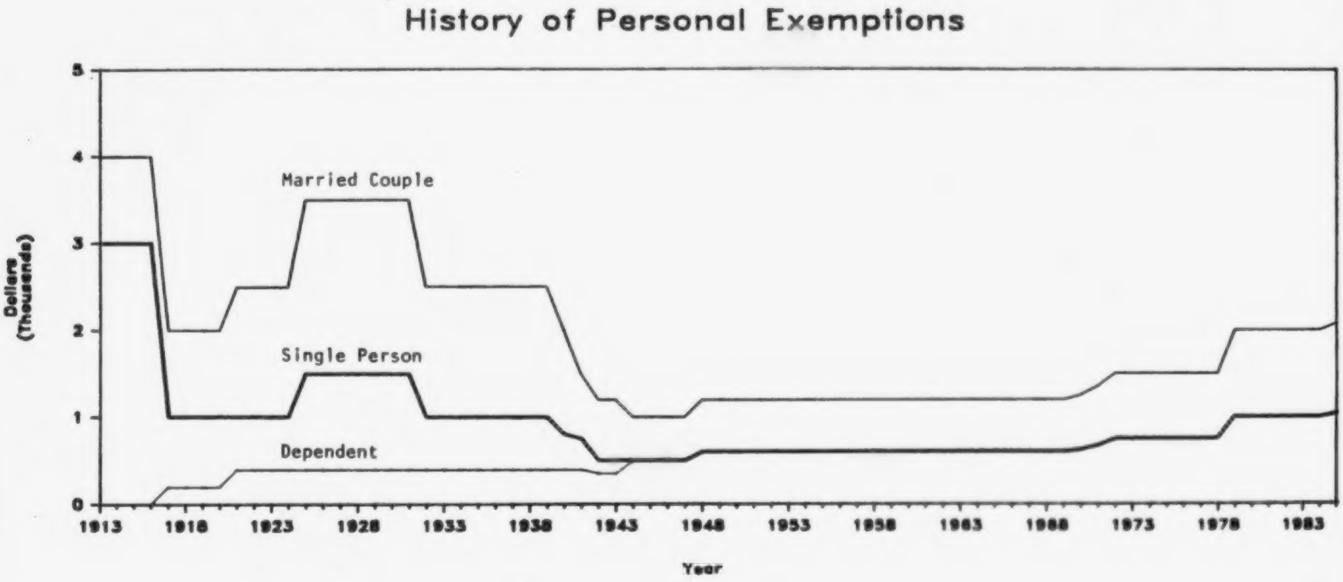

FIGURE 1

During the prosperous 1920s, as the need for revenues lessened, personal exemptions were increased. By 1932, the good times were long gone. The single and head of family exemptions were lowered to shore up depression-reduced revenues by extending the tax to more taxpayers. The dependent exemption rose, but remained low relative to the other exemptions. In 1939, the exemptions for single taxpayers, couples (and heads of families), and dependents were $1,000, $2,500, and $400 respectively. By 1944, the first two had been reduced to $500 and $1,000, and the dependent exemption had been increased to $500. For the first time, the exemptions were equal on a per capita basis. This alignment was retained in subsequent acts and persists today.[14] The establishment of per capita equality in 1944 was part of an effort to simplify the code as the tax was being extended to many new lower-income people to meet wartime revenue needs.

In 1948, the exemptions were raised to $600 for single taxpayers and dependents and $1,200 for couples and heads of families. They remained at these levels until 1970. During the intervening years, the real value of the exemptions eroded dramatically as the price level rose and, along with it, incomes and itemized deductions. Exemptions were further increased in the early 1970s and again in 1979. The Economic Recovery Tax Act of 1981 initiated the indexation of exemptions to the Consumer Price Index, but the effective date was held off until 1985. This year, the single and the dependent exemptions have been increased by $40 to $1,040 and the married joint filer exemption by $80 to $2,080 via indexation.

Dependency status.—The definition of a dependent for current federal income tax purposes differs from that originally specified in 1917. The first dependent had to be under 18 years of age or a mentally or physically incapacitated child. Within a year, the definition was broadened to include any closely related person meeting either qualification. In 1944, the definition was further broadened to encompass all closely-related people for whom the taxpayer provides more than one-half of total support.[15] The removal of the limits on age, and on self-support for children at this time, allowed college students to qualify for the first time. Since 1917, the definition of a dependent has been progressively broadened to encompass extended family obligations beyond those legally binding on the taxpayer.

Families of different sizes.— Personal exemptions cause family tax liabilities to vary with family size. This, however, is a crude adjustment for family taxpaying ability. The expenses associated with a child are most cogently measured for a family at the subsistence level; at that level, the costs are necessary, not discretionary. For families of different sizes at the subsistence levels, the ZBA and combined exemptions can play the role of ensuring that the family has a zero income tax liability. (During the 1960s and 1970s, Congress increased the taxpaying income threshold for the explicit purpose of making it nearer to the poverty level of income; this has

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[14] In one sense, dependent children are treated preferentially because their incomes are not aggregated with the other family income earned by their parents.

[15] As long as the dependent's gross income was less than $500. The gross income limit, which has since been raised to $1,000, is no longer applicable to taxpayers' children who are younger than nineteen or fulltime students.

not been the case, however, during the 1980s, during which the taxpaying threshold for families has continued to fall below the poverty level of income.)

Standard deduction or zero bracket amount.—In its earlier formulation as the standard deduction, the ZBA could be recognized more easily as a deduction that can be taken in lieu of all itemized personal deductions. It was introduced in 1944 at 10 percent of adjusted gross income (AGI), with a maximum deduction of $500, as a means of reducing complexity when many more lower-income people were becoming taxpayers. In 1944, the number of taxable returns had increased tenfold over the previous five years; lower personal exemptions, reduced to finance the war, had brought more people onto the tax rolls (Goode, 1976, p. 174). During the first few years after 1944, over 80 percent of taxpayers used the standard deduction. Its relative value fell during the 1950s and early 1960s as the percentage of AGI remained constant while itemized deductions continued to grow.

From its introduction in the Revenue Act of 1964 until the late 1970s, the minimum standard deduction was calibrated to poverty thresholds (Joint Committee on Taxation, 1978, pp. 38–39). After increasing steadily during the early 1970s, the two (single and joint-filer) standard deductions became flat dollar amounts and were incorporated into each tax rate schedule in the form of a ZBA.[16]

In 1964, the minimum standard deduction was $200 for both single taxpayers and joint-filers plus $100 per exemption. The standard deduction available to the taxpayer was the larger of this or the older percentage deduction and was capped at $1,000. The taxable income thresholds were set at roughly the poverty levels for unmarried individuals and couples. The minimum standard deduction for single taxpayers was set at more than half that for married couples filing joint returns because the poverty level for a single person maintaining a separate household is greater than one-half that of a couple. A new non-itemizers' marriage penalty—for two-earner married couples compared with two similar earners who are not married—was created as a byproduct of the alignment of the minumum standard deductions with the poverty levels. This penalty persists in the current tax code; in 1985, two-earner couples who do not itemize deductions could reduce their taxable income by $1,240 if they divorce.

Beginning in 1969, the percentage standard deduction and the minimum standard deduction[17] were raised periodically to keep the tax-exempt levels of income near the poverty levels, which were increasing with the price level. By 1971, the minimum standard deduction was a flat $1,300 for all taxpayers and was no longer related to the number of exemptions. In 1975, the single taxpayer and married taxpayer (joint-filer) minimum standard deductions were once again differentiated, and were raised to $1,600 and $1,900 respectively. Two years later, the standard deduction (effectively a percentage of adjusted gross income with maximum and minimum levels) was replaced by the ZBA. By 1979, the ZBA was

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[16] Instead of subtracting all itemized deductions from adjusted gross income as before, taxpayers choosing to itemize now subtract only itemized deductions in excess of the ZBA.

[17] The minimum standard deduction was often called the low income allowance.

$2,300 for single taxpayers and $3,400 for married couples filing joint returns (like the personal exemption, it is now indexed to the Consumer Price Index).

During the 1970s, the benefit of increases in the tax-exempt levels of income moved toward single taxpayers and childless couples and away from large families. Between 1970 and 1984, the ZBA increased approximately 110 percent for single returns and 210 percent for joint returns, while the personal exemption increased only 60 percent.

Child Care and Housekeeping Expenses as Costs of Earning Income

The base of the income tax is net income; that is, gross income with a deduction for the costs incurred in earning this income. Most personal consumption expenditures are not deductible,[18] but it is not always easy to distinguish between costs of earning income and personal consumption expenditures. One major task for tax policymakers, therefore, is to decide which expenses are properly deductible.

There is no unambiguous formula for making these decisions, because many business expenses also provide personal consumption, such as country club dues or business lunches. Similarly, many personal expenditures likely to be made under any conditions are also necessary for employment, such as expenditures on clothing and meals away from home.

Expenses for child care are among those that are hard to categorize. While necessary for the employment of some taxpayers, other taxpayers pay for child care even though only one parent works. Further, the decision to have a child is like a personal consumption decision in many ways. The problem for tax policymakers is to decide which child care expenditures are necessary for earning income and which are not.

Past legislative responses to this issue have reflected the judgment that child-care expenses are required if single parents and low-income couples are to support themselves and their children. The case has been judged less clear for married couples when the primary wage earner is able to support the family. Until 1954, child care expenses could not be deducted even if they could be shown to be necessary for gainful employment. The issue had been raised many times, but Treasury rulings and Court decisions had not allowed deductions for these expenses. The Internal Revenue Code of 1954 created a deduction, but didn't place it on equal footing with other expenses of earning income. Instead, the act allowed an itemized deduction for child care expenses and limited it to cases where it was felt that child care costs were necessary for supporting the family. The full deduction (up to a $600 annual limit) was allowed for all single parents and lower-income married parents when both worked. The maximum deduction for married couples was reduced as family AGI increased, and the deduction was further limited to the earnings of the spouse with lower earnings.

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[18] Exceptions are itemized deductions, such as interest, state and local taxes, medical expenses, and charitable contributions.

Although these limits targeted the credit toward lower-income married couples, few of these taxpayers actually benefited from it because they did not itemize deductions.

In 1963 and 1964, the Congress extended the deduction to women who had been deserted by their husbands (and were treated as single parents) and to working husbands with wives who were incapacitated or institutionalized (and were subject to the income limitation of other married couples.) The maximum deduction for two or more dependents was also made higher than for one dependent.

The child-care deduction was substantially expanded in 1971. For the first time, household service expenses were also deductible.[19] The maximum deduction was increased from $600 per year ($900 for two or more dependents) to $400 per month. For married couples, the family income limitation was also substantially increased, and the maximum deduction was reduced by only 50 cents (rather than a dollar, as before) for each additional dollar of AGI. The deduction had clearly become a benefit to middle-income taxpayers. This trend continued in 1975, when the adjusted gross income limitation for married couples was approximately doubled. As the deduction became more generous, there was concern that it might be abused by parents paying children or other relatives for child care. This led to an explicit restriction: payments to relatives did not qualify for the deduction if a dependent exemption could be claimed for the care-giver (even if the exemption was not actually claimed).

In 1976, the child-care deduction was changed to a credit, making it available to nonitemizers (as well at itemizers) and increasing its value for many lower-income taxpayers. The new credit was equal to 20 percent of dependent care expenses necessary for employment. Maximum expenses eligible for the credit were $2,000 for one dependent and $4,000 for two or more. However, no credit was allowed for older dependents or spouses cared for outside the home because the credit was not intended to apply to costs of institutionalization of dependents.[20] (Household service expenses ceased to be treated as a cost of earning income at this point.)

After 1976, payments to nondependent relatives could qualify for the credit if providing child care was employment according to social security regulations. This requirement was eliminated in 1978, because the Congress felt that care by relatives (in particular grandparents) was often superior to that provided by others, and believed that care by relatives could strengthen family ties (Joint Committee on Taxation, 1979, p. 64).

The credit remained essentially unchanged until 1981, when it was increased and targeted more toward lower-income taxpayers. The credit was still not allowed for institutional care, but day care outside the home for an incapacitated spouse or other dependent could qualify. Since 1981, there have been only minor changes in the credit.

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[19] Household service expenses included the employment of a domestic helper in the home even if the employee performed services in addition to child care. Payment for the services of a gardner, bartender, or chauffeur were not deductible. (Joint Committee on Internal Revenue Taxation, 1982, p. 58.)

[20] Expenses for institutional care could be deducted as an itemized deduction for medical care expenses.

REDUCED TAXES ON EARNED INCOME

At different times, the income tax code has contained provisions that reduce taxes on earned income. Reductions have been justified as a way to compensate for the costs of earning wages and salaries, since deductions for these costs are not fully allowed (a problem described above). Reductions have also been viewed as a way of providing work incentives and alleviating the burden of taxes for lower-income taxpayers.

Reduced rates on earned income were proposed in discussions that preceded The Income Tax Act of 1913 (Blakey and Blakey, 1940, p. 94). Subsequently, a credit for earned income was included in The Revenue Act of 1924 as part of an overall reduction in taxes. This provision allowed a tax credit of 25 percent of tax liability calculated on the assumption that total income was equal to earned income; the credit was capped at 25 percent of the taxpayer's normal tax. This provided assistance to those with low earned incomes who had other income, since the first $5,000 of taxable income (regardless of source) was treated as earned income for all taxpayers. Though only the first $10,000 of earned income was eligible for the credit, the benefits of this provision were not particularly targeted to low-income taxpayers. In fact, the $10,000 limit on earned income was raised to $20,000 in 1926, and to $30,000 in 1928 (Blakey and Blakey, 1940, pp. 270 and 299). The earned income credit was discontinued after 1931 because increased revenues were needed to reduce large deficits (Blakey and Blakey, 1940, p. 332).

A 10 percent credit for earned income was initiated with the Revenue Act of 1934. The first $3,000 of income from any source was treated as earned income, and earned income eligible for the credit was limited to $14,000 (Blakey and Blakey, 1940, p. 363). The Revenue Act of 1944 repealed the credit in an effort to simplify the tax and as part of the general tax increase in that year. It was argued at the time that the complexity that the credit added to the income tax was not worth the tax savings it gave (Paul, 1954, p. 382). The credit that was repealed proved to be the last earned income credit intended to reduce taxes for all taxpayers.

Current law allows for an earned income tax credit (EITC), but this credit differs from the credits of the 1920s to 1940s in both purpose and structure. The history of the EITC begins with The Tax Reduction Act of 1975, in which the EITC was introduced as a temporary provision.

In discussions prior to passage of the EITC, several concerns were expressed. The EITC was intended to provide a work incentive and to offset the burden of social security payroll taxes on low-income workers. In addition, it was meant to provide financial assistance to the working poor who had no tax liability. Toward this aim, the EITC was made refundable: if the credit was larger than the taxpayer's tax liability, the difference was refunded to the taxpayer in cash. The House version of the EITC reflected these general concerns, and was also intended to compensate poor families for rapidly rising food and energy prices. However, the final version of the EITC was targeted to specific families: the credit was restricted to families with children. This was done in part to limit the cost of the credit, but was also an explicit attempt to target work incentives to families most likely to be on welfare (Joint Committee on Internal Revenue Taxation, 1975, p. 33).

The credit was structured to be a percentage of a base amount, with a limit placed on the base. In 1975, the credit was equal to 10 percent of earned income, with a limit on the base of $4,000. Once family earned income exceeded the base, the credit was reduced ("phased out") by a fraction of each additional dollar earned. In 1975, the phaseout percentage was 10 percent, so that no credit was allowed to families with income over $8,000. Eligibility was limited to wage earners who provided a household for one or more dependent children, with the requirement that the wage earner must be able to claim the dependent exemption for at least one child.[21] Because the size of the credit depended on family income, married couples were required to file a joint return in order to receive the credit (Committee on Ways and Means, January 1976, pp. 1–2).

The Revenue Adjustment Act of 1975 extended the credit through 1976, and specified that refunds resulting from the credit were not to be considered income for purposes of deciding amounts of welfare benefits the family could receive. At that time, it was felt that reductions in welfare benefits would counteract the effects of the credit on work incentives for the poorest of families.

The Tax Reform Act of 1976 extended the credit through 1977. It also eliminated the requirement that the taxpayer must claim a dependent exemption for a child. Instead, the taxpayer was required to provide half of the cost of maintaining a household that included a dependent child. It also extended the credit to taxpayers maintaining a home (and entitled to a dependent exemption) for an adult disabled dependent (Joint Committee on Taxation, 1976, p. 114).

The credit was made permanent in 1978, with a number of significant changes. First, the maximum base of the credit was increased. Second, the income level at which the credit would be phased out was changed to allow taxpayers $1,000 of income above the credit base before additional income reduced the credit. This improved families' ability to estimate the value of the credit in advance of earning income or collecting income from other sources.

Third, the phaseout percentage was increased from 10 percent to 12.5 percent, which increased the tax burden on additional income for those affected. Fourth, the act made certain forms of nontaxable income (such as disability payments) eligible for the credit. This increased the credit for some families, but pushed other families above the income levels eligible for the credit. Fifth, eligibility was extended to taxpayers supporting adult dependent children even if not disabled or full-time students.[22] Finally, the credit was classified as earned income for purposes of Aid to Families with Dependent Children and Supplemental Security Income, reversing earlier treatment of the credit. This reduced welfare benefits and, incidentally, work incentives for families on welfare, since in some instances an additional dollar of income could cost a family more than a dollar in reduced welfare benefits, the reduced credit, and increased income and payroll taxes.

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[21] In 1975, the EITC required that a dependent child be under the age of 19 or a full-time student. In order to claim a dependent exemption, the taxpayer was required to furnish over half of the child's support.

[22] Married couples are required to be eligible for a dependency exemption for a child, i.e., pay over half of the child's support, not just half of the household costs.

The Deficit Reduction Act of 1984 made the credit somewhat more generous by increasing the credit percentage, and slightly reducing the phaseout percentage. In 1985, the credit is 11 percent of the first $5,000 of earned income, and is phased out at a rate of 12$\frac{2}{9}$ percent of income over $6,500.

Over the years, the credit has provided financial assistance to a large number of poor families. There have been some unforeseen effects, however. Many eligible families have not claimed the credit because they do not file tax returns. The credit has also provided a marriage penalty that is an incentive for married couples to divorce, since some married couples that do not qualify for the credit jointly could become eligible for two credits if they divorce and file as single parents.

TAX CONSEQUENCES OF DIVORCE

When a couple decides to separate or divorce, their tax status changes. Their tax will depend on how they divide the property from the marriage and on the levels of alimony and child support. A couple with children must decide who will claim the personal exemption for each dependent, and who will deduct medical expenses for the child. The legal relationship between parent and child also affects eligibility for head of household status, the earned income credit, and the dependent care credit. In addition, the tax code complicates decisions to remarry.

PROPERTY SETTLEMENTS

As discussed above, the principle that equal-income taxpayers should pay equal taxes regardless of their states of residence motivated the change to universal joint returns for married couples in 1948. However, this change did not entirely eliminate geographic differences in taxes paid; until recently, transfers of property between spouses in common law states could be taxable, since one spouse realized a capital gain or loss and the other spouse received income. (This was less an issue in community property states, where family property is considered to be jointly owned.)

The taxation of property transfers was particularly troublesome for divorcing couples. The equal division of community property between divorcing spouses was not taxable, since that property was by definition jointly owned. This was also true of equal divisions of jointly held property in common law states. However, the equal division of total family property in common law states was taxable if it involved a transfer of legal ownership from one spouse to another. Thus, except in rare cases where a couple held joint title to all family property, divorcing couples in some states were liable for more taxes than those in other states.

The Deficit Reduction Act of 1984 changed the tax treatment of transfers of property between married and divorcing couples. Transfers now receive the same treatment as gifts between spouses and therefore allow couples to divide property from a marriage without concern that the division will be taxable.[23] The act placed couples in common law states on equal footing with those in community property states.

ALIMONY AND CHILD SUPPORT

Current law allows the deduction of alimony by the payer and treats the payment as income to the recipient. However, this has not always been the case. The Revenue Act of 1913 did not explicitly address the tax treatment of alimony and child support. At that time, only a small percent of Americans paid taxes at all, and relatively few marriages ended in divorce. In 1917 the Supreme Court rules that alimony payments were not taxable income to the recipient under the 1913 act. As a result of this ruling the paying spouse was not allowed a deduction for the payments (Joint Committee on Taxation, 1984, p. 713).

Federal income tax treatment of alimony changed with the Revenue Act of 1942. This act made alimony payments deductible by the paying spouse, and taxable to the recipient. Because the payer was usually in a higher tax bracket than the recipient, this change reduced the couple's combined tax payments. This change was exceptional during the period when tax burdens on most Americans were increasing rapidly. At the time, the payment of alimony out of after-tax income was seen as an undue hardship that was growing as tax rates increased (Paul, 1954, p. 298). This change increased taxes for some recipients, but recipients living only on alimony often had incomes well below the taxable income threshold.

In 1942, it didn't matter whether the deduction for alimony was an itemized (personal) deduction or an adjustment to income like a business expense: because there was no standard deduction, the effect of both types of deduction were the same. This changed in 1944, when the standard deduction was introduced. From 1944 until 1976, alimony payments were treated as personal expenses like home mortgage interest: they were deductible only by those who itemized deductions. In 1976, alimony became an adjustment to income for the payer, which made the deduction available to those who use the standard deduction. There was, however, no corresponding change in the taxation of alimony to recipients.

The original decision of the Congress to make alimony an itemized deduction rather than an adjustment to income reflected the judgment that alimony was not a payment for services. This qualification meant that recipients of alimony at that time were denied the benefits of the earned income credit (except to the extent that the first $3,000 of income from all sources was presumed to be earned income). After this credit was repealed, in 1944, the question of the classification of alimony as earned income did not become important again until 1974, when Individual Retirement Accounts (IRAs) were established. An adjustment to income was allowed for contribution to an IRA, limited to a fraction of earned income. Alimony did not increase this limit. Likewise, when the earned income credit was created in 1975, alimony was not treated as earned income eligible for the credit, though it reduced the value of the credit like any other type of income. The Deficit Reduction Act of 1984 classified alimony as earned income (compensation) for purposes of the IRA limitation, but not for the earned income credit.

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[23] Since the Economic Recovery Tax Act of 1981, gifts between spouses have not been subject to gift taxes.

Unlike alimony payments, child support payments have never been deductible to the payer or includible in the taxable income of the recipient. If the paying spouse is in a higher tax bracket than the recipient, the couple's total tax liability can be reduced by structuring the support agreement to include larger alimony payments and smaller child support payments. A couple can cooperate to reduce their combined taxes and split the benefits between them. However, the incentive to do this is limited by the distinction that alimony stops with remarriage while child support does not.

Divorcing couples can also avoid tax if they disguise payments that are really property settlements as alimony, since the paying spouse can then deduct large lump-sum payments. To prevent this tax avoidance, the law until recently required that the payment must be "periodic." The Deficit Reduction Act of 1984 more clearly defines the circumstances under which payments from a divorced spouse are taxed as alimony, child support or property settlements.

WHO GETS CUSTODY OF THE TAX BREAKS

Many provisions of the tax code apply only to parents. For example, dependency exemptions, the deduction of a child's medical expenses, the assignment of the parent to single or head-of-household rates, and elgibility for the earned income and dependent care credits all depend on whether the taxpayer is supporting a child.

A separated or divorced couple must determine who will claim the child for purposes of these provisions. The parent with custody may not be able to benefit from these because of low taxable income, and might not actually pay the bulk of the costs of supporting the child. In 1967, rules were established for determining which divorced parent could claim the personal exemption for a dependent child. The parent with custody could normally claim the exemption, but a noncustodial parent who contributed at least $600 for the support of the child could claim the exemption if the parent with custody agreed to this in writing. Without such an agreement, the noncustodial parent who contributed $1,200 for one or more children could claim the exemption unless the custodial parent proved that he or she had contributed more than $1,200. The burden of proof was on the custodial parent (Joint Committee on Taxation, 1984, pp. 717–718).

The Deficit Reduction Act of 1984 revised the 1967 rules so that the custodial parent is presumed to be entitled to the dependent exemption unless he or she agrees to allow the other parent claim it. Waiving the claim on the dependency exemption does not disqualify the custodial parent from filing as a head of household, or from taking the earned income and dependent care credits. Under the act, both parents may deduct medical expenses that they pay for the child—for this provision, the child is considered to be a dependent of both parents. These new rules protect the claim of the custodial parent on the dependent exemption, but also reduce the cost if the parent waives the claim.

REMARRIAGE

The federal income tax contains several provisions that can make remarriage costly for taxpayers. A notable example is the one-time exclusion of capital gains on a home, established in 1964. The law allowed taxpayers over age 65 to exclude from tax up to $20,000 of the capital gain on a home. At first, this provision did not complicate remarriage for many taxpayers, since relatively few taxpayers divorced and remarried after age 65. In 1978, when the age was lowered to 55 and exclusion increased to $100,000, far more taxpayers were affected. A married couple may take the exclusion once one spouse turns age 55. Thus, a younger spouse may benefit from this exclusion even before age 55. If the couple then divorces, remarriage to a taxpayer who has not yet taken the exclusion would deprive the new spouse of the exclusion altogether (if the couple files jointly), or of a portion of the exclusion (if they file separately). The limit on the exclusion for a separate return is half of that for either a joint return or the return of a single person.

CONCLUSION

From 1913 through World War II (with only a few periods as exceptions), the federal income tax was adapted to a growing need for revenues. As more people become taxpayers and tax rates rose, provisions of the income tax were revised and revised again to minimize inefficiencies and reflect views about fairness. Beginning in the 1960s, more married women, especially married women with children, began to work outside the home. Divorce became more common. Revisions in the tax code in response to such changes have been incomplete, slow in coming, and often uncoordinated.

Women and families are affected by the federal income tax mostly because they constitute a majority of taxpayers, but also importantly because they play some special roles in society (such as being second-earners and providers of child care) while contributing directly and substantially to national income. Increasingly as heads of households and as second earners in two-earner families, women face higher effective tax rates on their income after employment-related expenses than their unmarried counterparts, especially those without dependents. While further revisions in the income tax must encompass many provisions not mentioned here, the necessary trade-offs between equity, efficiency, and simplicity will be the same.

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THE TAX TREATMENT OF HOUSEHOLDS OF DIFFERENT SIZE*

Eugene Steuerle**

Perhaps no change in the nation's tax laws has been more significant yet less recognized than the shift since the late 1940s in the relative tax burdens of households of different size. For both single and married persons with dependents, the tax burden has grown dramatically relative to households without dependents, whether measured by dollars or by average tax rates. Even the much heralded "marriage penalty" resulted less from an actual shift in relative tax burdens—singles received a tax reduction of only about $240 million in 1971 when income splitting was abandoned—than from the recognition by two-earner couples that they were not receiving the same tax treatment on a per-earner basis as were single individuals and unmarried couples.[1]

This shift in the tax burden of households of different size came about in subtle ways, without, as far as I can determine, any explicit debate by policy makers about the shift or even about whether it was intended. The shift occurred primarily because of a passive public policy toward dependents of taxpayers: personal exemptions were kept relatively constant while incomes of taxpayers increased substantially.

Perhaps one reason for this passivity has been the decline in average household size over recent decades. Certainly the rapid increase in the number of one- and two-person households would make less controversial the increased relative tax burdens of households with three or more members. Another factor may have been the lack of agreement on the proper tax policy regarding dependents. Although numerous theories are espoused, they often produce contradictory results. In examining these various theories, I conclude that there is more than a reasonable basis for granting tax allowances on the basis of household size and that these allowances are appropriate at all income levels. I tend to prefer exemptions over credits and find partial income splitting to be as justified for dependents as for spouses. But those views are less strongly held than my belief that, whatever the type of tax allowances, it should be large enough to compensate adequately for most differences in ability to pay, at least between households with dependents and households without dependents.

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[1] Footnotes at end of article.

CHANGES IN FAMILY ALLOWANCES, 1948-84

The principal means by which the Tax Code adjusts for family size is through the personal exemption. The personal exemption currently is $1,000 and is scheduled to stay at that level until 1985, when it will be indexed for inflation. In 1948, however, the personal exemption was $600. If the personal exemption had been indexed for income growth since 1948—in other words, if the exemption were to offset the same percentage of per capita personal income today as it did in 1948—then it would equal $4,600 in 1981 and rise to about $5,600 in 1984.

By almost any measure, this decline in the personal exemption has been the largest single change in the income tax in the postwar era. Exemption on taxable returns originally reduced the tax base by about 24 percent of total personal income during each year of the period from 1948 to 1945; today, the reduction is only about 8 percent. Even those numbers understate the magnitude of the decrease because exemptions formerly excepted large portions of personal income for nontaxable households as well.[2] Indeed, the increase in the tax base due to the decline in the personal exemption, and the accompanying decline in adjusted gross income [AGI] of nontaxable individuals, completely offsets the much more widely recognized decline in the tax base from *all* other sources: increase in net exclusions from AGI, itemizations, standard deductions, and credits.[3]

Changes in two other major tax provisions have had much smaller, although significant, effects on the distribution of tax burdens among households of different size. First, tax rate schedules have been altered. Prior to 1948, there was only one rate scheduled for married persons, heads of households, and single persons; if both spouses had incomes, however, they could file separate returns. Income splitting was available only in community property states. In 1948, income splitting was made universal for married persons, and in 1969 the rates for singles were lowered, thereby reducing the "single penalty" and increasing the "married penalty." For 1982 and thereafter, married couples will be allowed a partial deduction for the earnings of the spouse with lower earnings.

Second, there have been frequent changes in the zero bracket amount [ZBA] or standard deduction. Currently, the ZBA differs between joint returns on the one hand and the returns of singles and heads of households on the other. Like the tax rate schedules, there has never been an adjustment in the maximum amount of standard deduction or ZBA according to the number of dependents, whether cared for by married persons or single persons as heads of households. Thus, whenever family size adjustments are made through the ZBA, they tend to allow no reduction in tax liability for dependents.[4]

Although the standard deduction or ZBA was increased many times, especially in the 1970s, it offsets only a slightly larger portion of personal income than it did in the early 1950s. Standard deductions on taxable returns equaled about 4.5 percent of personal income during each year of the period, 1947 to 1953, fell to about 2.6 percent by 1963, rose to a maximum of 7.3 percent in 1977, fell again to about 5.4 percent by 1981, and under current law will fall continually relative to income after 1981, although at a reduced rate after indexing is introduced in 1985.

Tables 1 and 2 demonstrate the net result of changes in exemptions, tax rates, and ZBAs (or standard deductions) on the tax burdens of households of different household size. Table 1 compares taxes for households with incomes equal to median family income, assuming that a constant percent of income represents itemizable expenses. During the period from 1948 to 1981, and extrapolating to 1984, the tax burden of singles grows at a slightly lower rate than the tax burdens of joint returns with no dependents. As a percent of total income, however, the increase in tax burden for both is just under 5 percent. For households with dependents the change is much more dramatic. For joint returns and heads of households with two to four dependents, the increase over the same period ranges between 8.3 percent and 10.1 percent of income. Indeed, in 1948 most of these households paid no tax at all.

These changes in relative tax burdens are persistent throughout the whole period, 1948–1984. For instance, single persons and married couples with no dependents are scheduled to face essentially the same average tax rates in 1984 as they did in 1960. For households with dependents, however, average rates rise dramatically over the same period. A couple with two dependents has an increase of about 43 percent (from 6.9 percent to 9.9 percent) in its average tax rate, while for a couple with four dependents the increase equals 223 percent (from 2.6 percent to 8.4 percent).

In table 1 it is assumed that all households have incomes equal to median family income and that they itemize their deductions. A similar shift in relative tax burdens shows up at other income levels as well. Table 2 shows the shifts by household size in the minimum levels of income for which taxpayers owe any tax liability at all. These tax-exempt levels of income are determined by the standard deduction or ZBA and the personal exemption.[5]

TABLE 1.—TAXES FOR HOUSEHOLDS WITH MEDIAN FAMILY INCOME, BY FILING STATUS AND NUMBER OF DEPENDENTS, 1948-84

		Single		Joint						Head of household			
				0 dependents		2 dependents		4 dependents		2 dependents		4 dependents	
	Median family income [1] ($)	Tax ($)	Tax as percentage of income	Tax ($)	Tax as percentage of income	Tax ($)	Tax as percentage of income	Tax ($)	Tax as percentage of income	Tax ($)	Tax as percentage of income	Tax ($)	Tax as percentage of income
Year:													
1948	3,187	300	9.7	208	6.5	9	0.3	0	0.0	109	3.4	0	0.0
1954	4,167	534	12.8	402	9.6	162	3.9	0	0.0	282	6.8	42	1.0
1960	5,620	780	13.9	625	11.1	385	6.9	145	2.6	511	9.1	265	4.7
1966	7,532	962	12.8	741	9.8	524	7.0	328	4.4	668	8.9	451	6.0
1972	11,116	1,544	13.9	1,201	10.8	916	8.2	631	5.7	1,108	10.0	814	7.3
1978	17,640	2,602	14.8	2,101	11.9	1,768	10.0	1,408	8.0	2,093	11.9	1,722	9.8
1981 [2]	24,400	4,154	17.0	3,229	13.2	2,755	11.3	2,281	9.3	3,238	13.3	2,724	11.2
1984 [2]	29,600	4,293	14.5	3,375	11.4	2,935	9.9	2,496	8.4	3,468	11.7	2,988	10.1

[1] Note that the median family income does not represent the median income of the household units of various sizes. Singles have lower income than families, partly because the population of singles is concentrated in among the young and the aged. Families with dependents have higher incomes than all families because workers in families with dependents are usually in their prime working years.

[2] For 1981 and 1984, median family income is projected by taking median family income for 1979 and increasing that income by U.S. government projections of changes in the consumer price index. Tax/income for 1981 and 1984 change little when rates of income growth are projected through different methods.

Note: This example compares taxes for different size households earning the same income for various years between 1948 and 1984. Median family income was chosen in order to hold constant the relative status of the households being compared over those years. At income levels both above and below the median, there are similar trends in changes in taxes for households with dependents relative to households without dependents. The example assumes itemizable expenses equal to 23 percent of AGI in all years. For 1984, no allowance is made for a deduction if the married couple has two earners.

Source.—Median family income—U.S. Bureau of the Census, Money Income of Households, Families and Persons in the United States.

TABLE 2.—TAX-EXEMPT LEVELS OF INCOME BY FILING STATUS AND NUMBER OF DEPENDENTS, 1948–84

[Amounts in dollars]

	Per capita personal income [1]	Single	Joint			Head of household	
			0 dependents	2 dependents	4 dependents	2 dependents	4 dependents
Year:							
1948	1,425	667	1,333	2,667	4,000	2,000	3,333
1954	1,783	667	1,333	2,667	4,000	2,000	3,333
1960	2,226	667	1,333	2,667	4,000	2,000	3,333
1966	2,992	900	1,600	3,000	4,400	2,300	3,700
1972	4,555	2,050	2,800	4,300	5,800	3,550	5,050
1978	7,871	3,200	5,200	7,200	9,200	5,200	7,200
1981	10,900	3,300	5,400	7,400	9,400	5,300	7,300
1984	13,208	3,300	5,400	7,400	9,400	5,300	7,300
Percentage change							
1948–84	+827	+395	+305	+177	+135	+165	+119

[1] For consistency, per capita personal income for 1981 and 1984 were projected to increase at the same rate as median income in table 1.

Source—For per capita personal income—U.S. Bureau of Economic Analysis, *"The National Income and Product Accounts of the United States; Survey of Current Business."*

Although the ZBA in the near future will reduce the tax base by about the same percent of personal income as at the beginning of the 1950s, its general use in setting tax-exempt levels of income is partly responsible for the shift in tax burdens among households of different size. Tax-exempt levels of income for families of four have been kept just about at the official poverty level throughout most of the postwar period.[6]

In the Revenue Act of 1964, Congress explicitly acknowledged the intention of establishing a tax-free level of income approximating the poverty level. The method it adopted at that time and since then, however, was to increase the minimum standard deduction, but not the personal exemption.[7] Increases in the amounts of standard deduction are the same for couples with and without dependents, while increases in exemption levels are worth more to couples with dependents. Thus, tax-exempt levels for households without dependents have been moving closer and closer to tax-exempt levels for households with dependents.

Another influence on the relative tax burden of families of different size, at least from 1964 to the late 1970s, was the way in which the official poverty level was adjusted from year to year. Official poverty levels are redetermined each year by multiplying the previous year's poverty level by the percentage change in the consumer price index [CIP] between the two years. Incomes, however, have increased faster than prices. As long as Congress connects the use of the exemption and standard deduction to a price-indexed poverty level, their combined importance must continue to decline relative to income. When the dependency exemption declines relative to income, as noted before, the tax burdens of larger households move closer to those of smaller households.

There are several reasons why the standard deduction was favored over the exemption. Increasing the standard deduction was a cheaper means of raising tax-exempt levels; such increases were of no benefit to taxpayers who continued to itemize. Moreover, increases in the standard deduction supposedly simplified the Tax

Code by limiting the number of those who itemize. Finally, since exemptions for taxpayers and dependents were linked to exemptions for the aged, Congress may have been reluctant to increase tax-exempt levels for the aged at a time when their tax-exempt income from social security was increasing rapidly.

Whatever the public policy intent, tax-exempt levels of income rose much more slowly than income for all household sizes. For a family of four, for instance, the tax-exempt level in 1954 was about one and one-half times per capita personal income in the economy (see table 2). For 1981 the situation is reversed, and per capita personal income is about one and one-half times the tax-exempt level of income. Single persons had increases in tax-exempt levels greater than those that applied to joint returns with no dependents, but the difference was not nearly as great as between returns without dependents and those with dependents. Joint returns with no dependents, for instance, have increases in tax-exempt levels of 305 percent between 1948 and 1984; for joint returns with two dependents, the corresponding number is only 177 percent. For joint returns with more than two dependents, and for heads of households with dependents, the increases are even smaller.

These changes in tax-exempt levels, of course, refer only to income subject to taxation. As noted above, increases in exclusions for certain types of income have partially offset the decline in the exemption. In particular, income-conditioned transfers and social security income usually are excludable from taxation. Since most social security income is received by households without dependents, its exclusion also tends to favor smaller households relative to larger ones. On the other hand, food stamps and aid to families with dependent children are conditioned upon size of household. For households receiving these transfers, the effective tax-exempt level for economic income will vary with size of household more than on the basis of adjusted gross income. Nonetheless, most households receiving income-conditioned transfers have economic income (AGI plus excludable income) which does not exceed tax-exempt levels.[8]

THEORIES OF EQUITY AND INCENTIVES

There are a number of theories and considerations that influence tax policy regarding households of different size. Although there is some overlap, I have combined these considerations into two groups. The first group involves theories of equity which fall broadly into one of two categories: family assistance and ability to pay. Related closely to the theory of ability to pay are issues that are often ignored, yet may be implicit in the choice of type and size of tax allowance. These issues include the taxation of transfers, the investment or consumption nature of expenditures for dependents, and, finally, comparisons of intertemporal tax burdens over the life cycle. The second group of theories deals with incentive questions: the effect of taxes on the supply of work, on savings and investment, on population growth, and on the amount of dependent care provided. This group will be treated in a later section.

These theories or considerations often produce reasonable but conflicting results. I have therefore attempted, while reflecting my own preferences, to present this material in a comprehensive framework that will relate and balance these conflicting considerations.

Family assistance

According to this theory, an allowance for dependents is designed to ensure some minimum level of well-being for each dependent. The theory generally extends beyond taxpayers to nontaxpayers as well, and the minimum level of well-being is implicitly set by the maximum cash grant or tax credit available per child. The theory calls for a credit or grant based on family size, although the allowance may phase out as income rises.[9] If a tax credit is provided by the tax system, while a grant is used in the welfare system, the two systems may not mesh well, especially for those households that are in both systems at the same time. A common goal of welfare reform effort is to bring the two systems together in some logical fashion, such as replacing the personal exemption with a per capita credit integrated through both the welfare and tax system.

While the use of a credit is perhaps most appropriate under a family assistance theory, at various times substitution of a personal credit for the personal exemption has been proposed as a means to increase the progressivity of the tax system. It is often asserted that a credit is more progressive because the value of the exemption increases as marginal tax rates increase. In general, this argument is fallacious. Given any family size, exemption level, and rate structure, it is possible to design a credit and alternative rate structure that will give exactly the same level of progression.[10] Thus, the choice between a credit and an exemption, except under the constraint of a fixed rate structure, is not one of progression at all. It is primarily a question of how, at any given pretax income level, adjustments for tax liability should vary according to family size. Credits, for instance, will grant equal relief for each additional dependent. Exemptions will grant lesser relief as the number of dependents increase and the taxpayer moves to lower marginal rate brackets.[11]

Ability to pay

The traditional ability-to-pay argument assumes that families are the appropriate unit of taxation. If ability is to be measured by income, but only after some adjustment is made for subsistence costs, however defined, then the tax base will equal income over and above these subsistence costs.[12] As noted above, this was essentially the theory that was followed in setting exemptions and standard deductions from the mid-1960s through the late 1970s. Official poverty level budgets were equated with subsistence levels, and positive tax rates began at income levels above poverty levels, at least for smaller families.

The poverty level budget attempts to measure "equivalent" standards of living for different size families. By taking into account economies of scale, externalities of consumption, or the "public" or "club" nature of goods used by the household, it is determined that the incremental amount of income necessary to support an additional household member generally declines as household size increases.[13]

The Tax Code, however, adopts an "equivalency scale" only at tax-exemption levels of income. At higher standards of living, a comparable equivalency scale would require greater absolute income differentials for similar increases in household size. For instance, suppose that a couple is living at the poverty level, and $1,000 of additional income would be required to maintain a poverty level of consumption if a dependent is added to the family. Then the standard of living available to a couple living at the poverty level and a couple with a child is exactly the same if the latter has $1,000 more income than the former. If, however, other families generally provide their dependents with more than poverty levels of consumption, then a $1,000 exemption is inadequate to adjust for family size at most levels of income. Such considerations led A.C. Pigou to argue that dependent deductions should increase with income.[14]

Let us refine the rule under which horizontal equity is applied to the tax system under the ability-to-pay principle. It is sometimes stated that those with equal incomes, after adjustment for household size, should pay equal tax. This is somewhat misleading. At its root, ability to pay calls for equal sacrifice (total, as well as marginal) among equals, not equal tax. A better statement of the rule would be as follows: *households with equal before-tax ability to maintain a standard of living should have an equal after-tax ability.*

An example will demonstrate how this rule can be applied to the issue of taxation according to size of household. Suppose that a family of three needs an income level equal to 125 percent of the income of a family of two in order to have an equal ability to maintain the same standard of living. If a family of two has $20,000 of before-tax income, and a family of three has $25,000, the rule does not imply that both families should pay the same amount of tax. On the contrary, if the family of two pays $4,000 in taxes, then the family of three needs to pay $5,000 in taxes in order that both families have after-tax incomes which will allow them to maintain the same standard of living.

This logic strongly supports the case for income splitting among household members. If there are economies of scale in the household, however, each household member should not be granted the same exemption level, zero bracket amount, and other bracket widths. Instead, a type of income averaging is called for.[15] For instance, in the above example, a third family member would be attributed one-fifth of total family income, but that additional one-fifth would be taxed at the same average rate as applied to the remaining four-fifths of family income (the remaining four-fifths would be taxed as if it were earned by the two-person family).

Three observations are appropriate here. First, an equivalency scale, if it could be derived, may not require the same degree of income splitting at all income levels. At very high income levels, for instance, the addition of a family member may require a much smaller additional fraction of income to support the same standard of living. Vickrey, for instance, argues that "the presumption that dependents share in the family resources in some proportion to needs becomes weaker as the income increases."[16] Second, the issue of income splitting is not one of progression; any degree of progression can be reached by adjusting the rate schedule. The question is whether those with before-tax incomes sufficient to maintain equal standards of living should have after-tax incomes sufficient to maintain equal standards. Without splitting, households with dependents would have lower after-tax abilities even though they had before-tax abilities equal to those of households without dependents.[17] Third, this principle can be applied equally well to a progressive consumption tax as to a progressive income tax. An income tax taxes the ability to maintain a given standard of living, while a consumption tax taxes the standard of living itself. Nonetheless, the notion of income equivalency is not too different from a notion of consumption equivalency, and splitting would be equally applicable to both types of taxes.

If there are economies of scale, the ability-to-pay argument may also be used to justify smaller allowances or exemptions as household size increases. On equity grounds, smaller allowances would be required if smaller increments of income are needed to maintain a given standard of living as family size increases. From an efficiency standpoint, however, the argument can be stood on its head and used to justify increasing allowances as family size increases. Economies of scale imply that many consumption goods used within the household are in the nature of "public" or "club" goods for the household public, or, more narrowly, goods for which there are positive externalities within a close physical environment. Since more persons may share in the consumption of a good in a larger household, aggregate consumption may actually be increased by making transfers from smaller families to larger families. If one accepts the notion of an income equivalency scale such as in the poverty budget, then less income per person is needed to provide a given level of consumption in larger families. Yaakov Kondor argues that transfers to larger families are especially appropriate even when there is already equality in the sense of equal "income per equivalent adult" of each family (that is, when families of different sizes are considered equally well off after adjusting for family size, composition, etc.).[18] For the same cost, more people can enjoy the good being consumed, and thus welfare may be increased.

Related theories and considerations

Three issues are closely related to the theory of ability to pay.

The taxation of transfers.—One difficulty in applying ability-to-pay arguments to tax treatment of households is that income is transferred to dependents. There are a few areas of tax law on which there is less agreement than transfers.

If income is perceived only as rewards to factors of production, then transfers are not income to recipients. In arguing against income splitting for spouses, for instance, Moerschbaecher states that "the Internal Revenue Code is premised on the taxation of the entity earning the income, and that the concept of sharing of income . . . is simply not the theory on which our entire income tax system is based." [19] On the other hand, if income is to be taxed to the person "enjoying" or consuming the income, then it is the transferee, not the transferor, who should be taxed. Michael McIntyre and Oliver Oldman, for instance, argue that family income spent or saved by the parents for the benefit of their children is properly taxable to the children.[20] In any case, if transfers are taxed to recipients, while donors are taxed on income which is transferred, then some income would appear to be taxed twice. If both a donor and a recipient have the ability to use income as they wish, however, then both have an increased ability to pay resulting from the transferred "income"—after all, over time both could have consumed the income if they wished.

Current law is ambiguous as to which of these views is correct and has adopted no consistent treatment of transfers. Income is generally taxed to the earner because administratively it is difficult to measure who consumes the income. Tax brackets for joint returns, however, are widened relative to single returns, thus allowing some couples to treat a portion of the income as being transferred between them. In the case of alimony, payments are deductible to the transferor but taxable to the recipient. Child support payments, however, are viewed as similar to obligations of parents living with their children and, thus, neither taxable to the children nor deductible to the transferor. In the case of large transfers of wealth, some of the transfers may be taxable under the estate and gift tax, even though the income generating the transfer may first have been taxed under the income tax.[21]

When transfers are deemed to be charitable, they receive especially favorable treatment; if the donor itemizes deductions, the income generating the transfer is taxable neither to the donor nor the recipient. Various special rules attempt to prevent "personal" transfers from being deductible; for instance, one can give deductible contributions to the poor through a legally exempt organization but not directly. Although deductions are allowed only for certain "social" purposes, the distinction between eligible and ineligible organizations seems to be based not so much on need—a visitor to a museum, a college student, or a member of a church is probably no more needy than the average person—as on the remoteness of the transferor from the transferee. From an administrative viewpoint, this makes sense, as it is almost impossible to monitor personal transfers. The limitation is also attributable, I believe, to a perception that incentives for giving are not necessary for persons close to us or for small groups with closed memberships. Incentives, however, are needed to generate giving to persons remote from us and to large organizations which offer their services freely to all.[22]

There is no easy resolution of this debate. One general rule seems to be that transfers are deductible to the transferor if those transfers are for purposes desired or expected by society, for example, charitable transfers, transfers to spouses, and some amount of transfers to dependents. Still, the code is not consistent in its treatment of transfers. Complicating the issue further is that in the case of intrafamily transfers, it is generally impossible to know the exact amount of income transferred, so that, even if the transferee is to be taxed, one must resort to devices such as exemptions and income splitting as approximations. Moreover, capital income and some self-employment income is already easily redistributed among family members so as to minimize tax burdens, while wage and salary income cannot be redistributed at all; thus, more than complete income splitting is available for capital income,[23] while no splitting at all is allowed for wage income. Finally, personal exemptions can be taken by children against their own income at the same time that the parents claim dependency exemptions. This double exemption violates all theories of the taxation of transfers.[24]

Dependents as consumption and investment.—Related closely to the question of transfers is the correct labeling of the services provided to dependents, in particular, children. Do these services indicate consumption by the providers, consumption by the dependents, or investment in the dependents? Although I recognize the extreme limitations of applying such economic labels to activities that are often better analyzed and understood from a social perspective, the tax treatment of any transaction is dependent upon the economic label given it, so the label may as well be accurate.

The trend in recent years toward equalization of tax burdens regardless of number of dependents implicitly reflects the view that the raising of children is primarily a consumption good to the providers. Typical of this belief is the statement by Henry Simons, "It would be hard to maintain that the raising of children is not a form of consumption on the part of parents."[25] Accordingly, parents should be granted no tax relief for a type of consumption that they choose to enjoy. Related to this view is the premise that the services of a homemaker are provided primarily to the homemaker or to the homemaker's spouse, rather than to dependents such as children. Thus, many authors regard as inequitable the nontaxation of goods provided in the home.

If, however, most of the services are not provided to the homemaker, but represent income or consumption of the dependents, then we should be less bothered if the provider of the services is not taxed on the recipient's income. Moreover, if the recipient's total income is less than some reasonable tax-exempt level of income, then nontaxation of both homemaker and dependent may indeed be an appropriate solution. As for actual cash outlays for the recipient, they also should be taxed at the marginal rate relevant to his standard of living rather than at the higher marginal rate that would apply if such expenditures were treated as consumption of the providers. Thus, income splitting would be appropriate for such expenditures.

In the case of children, many of the services provided by the caretaker and the goods transferred by the original earner of the income may not even be consumption. A society which uses such phrases as "investment in our youth" is one which believes, rightly or wrongly, that many expenditures of money and time on dependents are investment, not consumption.

The Tax Code treats investment in physical assets as eligible for investment credits. Moreover, future flows of cash from investment are not all taxed; through capital cost recovery or depreciation allowances, the entire investment can be recovered without taxation (indeed, some have argued that capital cost recovery provisions yield an effective rate of taxation of income from depreciable assets that may be negative).

In the case of investment in human capital, the tax treatment is different again. Many educational goods and services are provided free to individuals. The income devoted to that investment is deducted by the charitable giver, the property taxpayer, and indirectly by the student and parent who "pay" for these services through forgone earnings.[26] By the same token, the value of the investment is not "recovered" over the life of the investment. Cash wages of an individual are not only a return on human capital, but also a depreciation of the capital. Therefore, the deduction of the cost of educational services may compensate for the nondepreciation of the human capital (indeed, it is equivalent to expensing of the investment). In the case of educational services provided through cash payments from private, noncharitable sources, however, no deduction is allowed for the expense, and no depreciation is taken over the life of the recipient.

If the care of children is investment in human capital, neutrality as well as equity would argue for tax treatment similar to that provided for other investments. Obviously, since there are different treatments of different types of investment, several comparisons could be made. Under any comparison, it would not be unreasonable to allow some deduction for the expense of investment in both cash outlays and the forgone earnings of caretakers. To the extent that the investment results in a later increase in the wage income of the dependent, the deduction is especially warranted because, as noted above, no depreciation is allowed against future wage receipts even though those receipts include a return of capital as well as income from the capital.[27]

One can carry this argument to an extreme. As Harold Groves states, were one to argue that "consumption outlays . . . are a cost of maintaining the labor supply, one could easily stretch this doctrine to exclude all income from the tax base." [28] A balanced position, it seems to me, would be that some portion of the services and goods provided to children, especially those which are educational, could reasonably be classified as investment and therefore deductible.

The life-cycle distribution of tax burdens.—Many persons view the choice of tax allowances for dependents only on the basis of within-period differences in ability to pay between households with and without dependents. There is a danger, however, in comparing the tax burdens of different households at only one point in time rather than over a life cycle. The proper treatment of dependents is as much a question of the intertemporal distribution of tax burdens for each person as one of the distribution among persons in households of different size. At one point in our lives practically all of us are dependents in a household, and at other points in our lives most of us care for dependent children or parents. Even if all of us came from households of equal size and had an equal number of dependents, we still might want a tax system that takes account of differences in ability to pay according to periods in which we belonged to households with dependent children. Disregarding problems of transition to a new tax system for taxpayers who have already lived a good part of their lives under a given tax system, the choice of tax allowances for dependents is in large part a decision as to the distribution over time of our own lifetime tax burdens.

INCENTIVE THEORIES

Incentives to work, save, and invest

From the standpoint of incentives to work, save, and invest, the tax allowance for dependents with the greatest incentive effect would be to allow some form of income splitting. Increases in personal exemptions and credits reduce the tax base by setting aside a certain amount of income to be taxed at a zero rate. Under a fixed revenue constraint, providing tax allowances for dependents by increasing dependency exemptions or credits results in an increase in the average rate of tax on the remaining tax base and may therefore result in an increase in average marginal rates as well.[29]

This argument can be carried only so far. As long as other changes may be made in the tax laws, increased exemptions and credits can also be used in connection with policies that favor lower average marginal rates. For instance, the rate schedule that applies to the taxable base itself can be made more proportional. Dependency exemptions can also be separated from other personal exemptions. It should also be noted that an exemption provides a greater lowering of average marginal tax rates in the population than does a reduction of the lowest rates in a progressive rate schedule. The latter change is equivalent to a flat credit for all persons with marginal rates above the lowest rates, while exemptions lower taxable income and therefore reduce the marginal tax rate of some persons at all income levels.

Population policy

According to one theory, any adjustment for family size lowers the tax burden of the family and is therefore an incentive to have children. Mirrlees "suppose[s] that most orthodox economists would take this view, that excessive population makes the environment unpleasant, and that parents should choose family size under the constraint of paying for these external diseconomies." [30]

While I find extreme the view that the marginal value to society of any child (or any adult, for that matter) is negative, there seems to me to be little justification in tying tax allowances for dependents to a population policy, no matter what the goals of that policy. The tax system is not well designed for population measures. In truth, the system can affect the actual decision to have children only by punishing or rewarding the caring for dependents after they are born. Zero or low allowances for child dependents would likely imply low allowances for elderly and disabled dependents as well.

Actually, tax allowances for children, even if fully adjusted for ability to pay, would still be a fairly small percentage of income. For instance, a dependency exemption of $1,000 increases the after-tax income of a median income family by only about 1.1 percent in 1981. Changes in these tax allowances are therefore likely to have only small effects on the net cost of raising children. Much more significant in affecting the net cost of raising children have been other institutional changes, such as the development of reliable public and private retirement systems. In some societies, children are expected to support parents in their old age; this makes the net *individual* cost of bearing children much lower than in a society where the children provide such support through public rather than private support, or parents provide for their own retirement.

Finally, it should be noted that if tax allowances for dependents do have strong incentive effects, and if the cost of caring for dependents is considered to increase with income (for example, higher income individuals would provide more education and housing to their offspring), then almost any design of dependent allowance other than partial income splitting is likely to create perverse effects across income classes by offsetting the cost of childbearing and care of elderly parents more for one class than another. A similar observation regarding differences between welfare allowances and tax allowances has been made by Gerard Brannon and Elliott Morss.[31]

Incentives for caring for dependents

Dependents are by nature individuals who must rely on others for some or most of their care. Society as a whole recognizes an obligation to care for these individuals, although it accomplishes this care primarily through the family. In cases in which the family cannot provide, alternative sources of income are made available either through welfare or social security. In starkest terms, societal programs today are based primarily upon the assumption that care of dependents is inelastic with respect to both price and income (at least at incomes above welfare levels). Thus, not only are tax allowances for dependents limited, but family assistance payments are available only for dependents in poor families, and charitable transfers usually are deductible only when made to remote or large groups.

If society instead were to care for all dependents through government programs, the revenue cost—and related efficiency cost—would be staggering. Relying on the family is therefore a fundamentally sound and efficient approach. Nonetheless, I think it would be a mistake to pass over this issue without at least noting that if there is some elasticity of response to caring for dependents, then there may be indirect costs to keeping the tax allowance low.

As I argued regarding population policy, however, almost any tax allowance is likely to make only a small differential in the cost of caring for dependents or not caring for them,[32] and its direct incentive or disincentive effect is therefore likely to be small. Perhaps of more importance here may be the symbolism involved. If families with dependents lower their standards of living more through payment of taxes than do families without dependents, then the former group may indirectly come to believe that society places little value on dependent care. More likely, however, societal values influence the tax policy rather than flow from it.

SUMMARY AND RECOMMENDATIONS

Since World War II, the tax burden of households with dependents has grown dramatically relative to households without dependents, whether for single or married categories. One reason for this shift in tax burdens has been the lack of any consistent agreement on the proper tax policy regarding dependents.

My review of the theories and considerations regarding tax allowances for dependents has led me to believe that these allowances are apprmisspelled appropriate and that the current dependency exemption is inadequate by almost any standard. Tax allowances are unnecessary only if income should be taxable to the original earner, regardless of the standard of living the earner can obtain, if investment in dependents or expenditures for their consumption are to be treated as only consumption of the donor, or if the Tax Code is a relevant and useful tool for implementing an accepted population policy of discouraging childbirth. Each of these requirements is in my opinion unacceptable or unmet, though not irrational.

If the view of the tax allowance is that it is only meant to provide family assistance at low income levels, then the current allowance may be adequate or even unnecessary at higher income levels. This view should also find the current exemption to be rather awkwardly designed: the amount of assistance at low income levels is quite small, and the assistance is much more related to the needs of the taxpayer alone (through zero bracket amounts and taxpayer exemptions) than to additional needs caused by dependents (through dependent exemptions).

Ability to pay, however, is the standard equity theory by which the tax system is normally judged. If ability is to be measured by income above subsistence, then the current exemption is inadequate according to the existing "official" measure of poverty or subsistence. While this measure and other measures of poverty and subsistence are subjective and may be criticized for a variety of reasons, they have tended over the last two or three decades to rise only with the price level and, therefore, to decline relative to income. At the same time, the exemption for dependents has remained relatively constant and has not even increased with the price level.

The theory of ability to pay holds that units with equal ability should make equal sacrifice. The notion of income equivalency recognizes that a large household will not be able to maintain the same standard of living as a small household with equal income, but that the difference is not proportional to the number of individuals in each household. The setting of tax-exempt levels of income higher for larger households, but not proportional to the number of family members, means that income equivalency, however subjective may be its measurement, is inherent in the structure of the tax system. Then to deny the same tenet at higher income levels is inconsistent. As a result, the current Tax Code violates the principle that those with equal ability to maintain a standard of living before tax have an equal ability after tax.

If transfers are treated as income of the recipients, or if the care of children involves some component of investment as well as consumption, then tax allowances for dependents are again appropriate at all income levels. A tax allowance similar to income splitting would again be called for, although the rate of splitting could reasonably be thought to decline at higher income levels. If transfers are taxable to the transferee, some notion of an equivalency scale still seems to be necessary to avoid full income splitting among all household members.

If taxes for each person are to be adjusted for life-cycle differences in ability to pay according to periods in which the person resides in a household with dependents, then tax allowances for dependents are a reasonable means of making such an adjustment. And finally, if one is concerned with the symbolism behind tax measures, and if society places a value on both dependent care and work outside the home, then a neutral signal—one that acknowledges the inherent value of both types of effort—might be a dependents' allowance. The allowance better recognizes the extent to which household care—at least the level of care that society expects—reduces the standard of living that can be maintained by the taxpayer.

How might we move from here to there? My own compromise proposal would be to allow, for joint returns with dependents, the use of a tax rate schedule in which brackets are at least twice as wide as those that apply to single persons. Such income splitting would eliminate the marriage penalty for couples with dependents and, in addition, recognize that the ability to pay of a family with dependents is lessened by the presence of dependents.

Another rate schedule would be provided for heads of households with dependents and to married couples without dependents. This schedule might be estimated from the single schedules by assuming some income splitting, such as 70:30. Heads of households would pay lower taxes relative to singles than they do now; those without dependents and filing joint returns would pay a greater share.

The change for heads of households would be especially significant. They have had the greatest increase in taxes (relative to singles and those filing joint returns) over the previous three decades; moreover, as long as the marriage penalty is reduced outside of the rate structure, their tax burden relative to the tax burden of those filing jointly will continue to increase.

Any remaining marriage penalty could be addressed with a device (even optional filing), which would be much less complicated than all current options simply because there would be a smaller percentage of couples with any potential marriage penalty. The addition of a third schedule also makes explicit that income splitting is being allowed for dependents and would logically, therefore, be accompanied by a requirement that dependents' income be pooled with the family's income for tax purposes.

Similarly, I would provide that there be three ZBAs: one for single returns, a second for joint returns with no dependents and returns of heads of households, and a third for joint returns with dependents. The ZBA for joint returns with dependents would again be at least twice as large as for single returns. Since the ZBA is the first bracket in the tax tables, this change can be accomplished simply by applying the same splitting formula to both the positive and zero rate brackets.

Finally, the dependency exemption would be separated from other personal exemptions and raised from its current level at approximately the rate of growth of per capita income. This solves the problem of introducing too many rate schedules and at the same time makes some allowance for larger family sizes. Those attentive to questions of population or marginal tax rates may be somewhat concerned with the raising of the exemption level. Much of the additional tax allowance for dependents is granted, however, by lowering rates through the addition of only one rate schedule to apply to all households with one or more dependents; the concern therefore should be minimal.

My principal conclusion is that adjusting for family size is reasonable at all income levels and should compensate for differences in ability to pay between households with dependents and households without dependents. Such changes can be made under almost any requirement of tax progressivity and with little or no effect on various incentives or disincentives that might be desired. Finally, whatever policy that is adopted should be made explicit; changes in the relative distribution of tax burdens across family size should be made by conscious choice and not as the accidental outcome of passive public policy.

APPENDIX TABLE 1.—THEORIES OF TAX ALLOWANCES FOR DEPENDENTS

	Supportive of tax allowances for dependents	Adequacy of current tax allowances	Further remarks
Family assistance	Yes	Inadequate at low income levels (if the tax system is meant to provide this assistance)	The current tax provides only a small amount of assistance at low income levels; welfare programs have usually been used to provide family assistance.
Ability to pay			
Equal tax for taxpayers with equal levels of income above subsistence payments.	Yes	Inadequate at "poverty" levels, especially for larger families	Equivalency scales are implied at subsistence levels, but not at other income levels.
Related or supporting theories.			
Tax transferor	No		Some exception is usually made for transfers necessary to provide a subsistence-level standard of living for the family.
Expenditures on dependents as consumption of taxpayers.	No		Again, an exception is usually made for subsistence-level income, implying that only expenditures on dependents above subsistence levels are consumption to taxpayers.
Equal sacrifice for equals (equal after-tax ability to maintain a standard of living for those with equal before-tax ability).	Yes	Inadequate at all income levels	Partial income splitting is required with progressive rate structure. Similar arguments would apply under a standard of living measure of equity with a consumption tax.
Related or supporting theories.			
Tax transferee	Yes	Inadequate at all income levels	Limits are usually placed on extent to which transfers are added to recipients' income but subtracted from donors' income. Examples: gifts to friends, large wealth transfers. Perhaps only transfers "desired" by society should be deductible to donor, e.g., charitable gifts, care of dependents.
Expenditures on dependents as consumption of dependents.	Yes	Inadequate at all income levels	Without resorting to equivalency scales to measure ability to pay of transferee, dependent's portion of family income will be taxed under tax rate schedule similar to taxpayer's.
Lifetime considerations (vary taxes over life cycle).	Yes	Inconclusive	Size of allowance depends upon extent to which taxpayers wish to take account of ability to pay between periods according to presence of dependents.
Work, savings, and investment	Indifferent		Related design of overall tax structure may be important; income splitting gives greatest decline in average marginal rates, ceteris paribus.
Population	No (if disincentives desired) Yes (if incentives desired)		Even if disincentives or incentives are desired, the tax system may be an inappropriate vehicle; incentive levels are probably too low to make much difference.

APPENDIX TABLE 1.—THEORIES OF TAX ALLOWANCES FOR DEPENDENTS—Continued

	Supportive of tax allowances for dependents	Adequacy of current tax allowances	Further remarks
Care of dependents	Yes	Inconclusive	Incentives probably make little difference; if symbolism is important, one measure of neutrality may be to require equal sacrifice for equals.
Investment in human capital (or expenditures on dependents as investments).	Yes	Inconclusive	Size of allowance depends partly upon extent to which other investments are expensed; consideration may be based more on equity across investments than efficiency since no incentive is provided if amount of investment is assumed in setting allowance.

Source.—Author.

NOTES

1. The revenue cost of allowing married couples the option of being taxed as singles is much greater than the revenue gain from reducing the single rate schedule so as to provide for income splitting.

2. Nontaxable households include those who filed, but owed no tax, and those who did not file.

3. Michael Hartzmark and Eugene Steuerle, "Individual Income Taxation, 1947-79," *National Tax Journal*, June 1981, pp. 145-66.

4. There are some exceptions. Between 1964 and 1970, there was a minimum standard deduction which increased by $100 per dependent for taxpayers meeting certain requirements.

5. During the years 1975-1978 a general tax credit also increased the tax-exempt level of income. The general tax credit was replaced after 1978 with an increase in the exemption level.

6. Generally, Congress has compared poverty levels and tax-exempt levels only for singles and for families of four, but not for families of size greater than four. Tax-exempt levels have been constantly below official poverty levels for large households.

7. In 1964 singles were judged to have poverty levels which were much higher than one-half the level for a couple; the remedy applied until the late 1970s was to increase the standard deduction for single returns at a much faster rate than for joint returns.

8. Unfortunately, tax and transfer systems are not well integrated in the United States. It is not clear whether transfer income should be taxed through the income tax if that income effectively is being taxed (through a phase-out of the welfare benefit) within the transfer system. By the same token, it is not clear whether the tax-exempt level should be defined by the income level at which the transfer income begins to phase out, or the level at which taxes paid exceed transfers received.

9. Howard W. Hallman, "A Proposal for a Graduated Family" Center for Governmental Studies, Washington, D.C., 1971.

10. Gerald Brannon and Elliott R. Morss, "The Tax Allowance for Dependents: Deductions versus Credits," *National Tax Journal*, December 1973; Emil Sunley, "The Choice between Deductions and Credits," *National Tax Journal*, September 1977.

11. Although a switch from an exemption to a credit can be designed to provide no change in tax burdens or progressivity among families of a given size, at other family sizes there is a shift in tax burdens. For instance, the design of an equivalent credit structure is usually such that at high incomes, large families would prefer the exemption, while small families would prefer the credit.

12. Alfred Marshall, *Principles of Economics* (London: Macmillan & Co., 1938), p. 135.

13. Note, however, that official poverty levels may show that larger increments of income are needed for typical families as the number of dependents increases. This is a result of the older average age of children in families as the number of children increases.

14. A. C. Pigou, *A Study in Public Finance* (London: Macmillan & Co., 1928), pp. 101-3.

15. William Vickrey, *Agenda for Progressive Taxation* (Clifton, N.J.: Augustus M. Kelley, 1972), pp. 295-96.

16. Ibid., p. 296.

17. In the simple case where expenditures on consumption equals income, of course, households with dependents would also have lower standards of living.

18. Yaakov Kondor, "Optimal Deviations from Horizontal Equity: The Case of Family Size," *Public Finance/Finance Publiques*, vol. 30, no. 2 (1975), pp. 216-21.

19. Lynda Sands Moerschbaecher, "The Marriage Penalty and the Divorce Bonus: A Comparative Examination of the Current Legislative Tax Proposals," *The Review of Taxation of Individuals* (Spring 1981).

20. Advocating in theory a type of income splitting on the basis of family size, they eventually turn to the exemption (although perhaps varying by number of dependents) as an alternative means of achieving this income splitting. Michael J. McIntyre and Oliver Oldman, "Taxation of the Family in a Comprehensive and Simplified Income Tax," *Harvard Law Review*, vol. 90 (June 1977), pp. 1573-1630.

21. Eugene Steuerle, "Equity and the Taxation of Wealth Transfers," *Tax Notes*, September 1980, pp. 459-64.

22. Richard Goode, in *The Individual Income Tax* (Washington, D.C.: The Brookings Institution, 1976), argues that incentives are the primary purpose of the charitable deduction.

23. Exemptions are available twice for dependents with capital income. In addition, more than a proportional share of capital income may be given to dependents as long as labor income keeps the marginal tax rate of the taxpayer above that of a dependent.

24. One solution to this last problem is to combine together the income of all family members and then to provide tax allowances for dependents, whether they be credits, exemptions, income splitting, etc.

25. Henry Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938), p. 140.

26. See Michael J. Boskin ("Notes on the Tax Treatment of Human Capital," in Conference on Tax Research, 1975, Washington, D.C., 1976) for the argument that the bulk of educational investment is financed out of forgone earnings of students.

27. Note that while this is roughly equivalent to "expensing," it still may imply a positive tax rate if the deduction (e.g., through forgone earnings) is taken at a lower marginal tax rate than the rate which applies to the future flows of wage receipts.

28. Harold M. Groves, *Federal Tax Treatment of the Family* (Washington, D.C.: The Brookings Institution, 1963), p. 10.

29. While *replacing* credits with exemptions, or vice versa, can be designed so that no change is made in overall progressivity, *increasing* either of them under a fixed revenue constraint inevitably means that tax rates on the remaining tax base will have to be increased.

30. James A. Mirrlees, "Population Policy and the Taxation of Family Size," *Journal of Public Economics*, vol. 1 (1972), p. 170. The belief that exemptions influence child-bearing decisions has been reflected in a few bills in Congress. For instance, Senator Packwood once proposed that exemptions not be available for more than two dependent children in any household. See S. 3632, introduced March 25, 1970, and S. 3502, introduced February 24, 1970.

31. Brannon and Morss, "Tax Allowance for Dependents," p. 607.

32. No distinction is made here between indirect costs of caring (forgone earnings) and direct costs (payments for child care). The tax system, partly through the existing credit for child and dependent care expenses, does provide some differential incentive in the method of care provided. That subject, however, is not treated in this paper.

FEDERAL TAX POLICY AND THE FAMILY: THE DISTRIBUTION OF THE DEPENDENT EXEMPTION, THE CHILD AND DEPENDENT CARE TAX CREDIT, AND THE EARNED INCOME CREDIT BY ADJUSTED GROSS INCOME CLASS, TAX YEAR 1982

Stacey M. Kean*

INTRODUCTION

The Federal individual income tax includes several provisions that relate to families with children. These provisions include the dependent exemption, the child and dependent care tax credit, and the earned income credit. This report describes these three provisions of our tax system and summarizes the use of these provisions by adjusted gross income class for the year 1982.

I. THE PERSONAL AND DEPENDENT EXEMPTION

The Federal income tax code provides for personal and dependent exemptions which serve to reduce the taxable income of the taxpayer. The personal and dependent exemption is $1,040 for tax year 1985 and will be indexed for inflation thereafter. Personal exemptions have four major functions:

1. Keeping the total number of returns within manageable proportions and particularly holding down the number with tax liability less than the cost of collection;
2. Freeing from the tax the income needed to maintain a minimum standard of living;
3. Helping achieve a smooth graduation of effective tax rates at a lower end of the scale; and
4. Differentiation of tax liability according to family size.[1]

The personal and dependent exemption together with the zero bracket amount (formerly the standard deduction) establish a tax threshold, or level of income below which income is not taxed. It has been argued that taxation of incomes below this minimum level could reduce "health and efficiency and result(s) in lower economic vitality, less production, and possibly higher public expenditures for social welfare programs."[2]

The Federal Tax Code provides for personal and dependent exemptions in several categories. There are exemptions for taxpayers, exemptions for age 65 or over, exemptions for blindness, and exemptions for dependents. Exemptions for dependents include exemptions for children, both at home and away from home; exemptions for parents, and exemptions for other dependents. Table 1 lists the types of exemptions and their share of total exemptions.

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[1] Goode, Richard. The Individual Income Tax. Washington, The Brookings Institution, 1964. p. 224-225.

[2] Pechman, Joseph A. Federal Tax Policy. Washington, the Brookings Institution, 1983. p. 78.

TABLE 1.—TYPES OF PERSONAL AND DEPENDENT EXEMPTIONS AS A PERCENT OF ALL EXEMPTIONS, TAX YEAR 1982

	Percent of all exemptions
Type of exemption:	
Taxpayers	60.92
65 or older	6.01
Blindness	.11
Dependents	33.00
Children	31.37
At home	30.39
Away from home	.98
Parents	.72
Other dependents	.88
Total	100.00

Source: Calculated by CRS using U.S. Department of the Treasury, Internal Revenue Service, 1982 Statistics of Income, Individual Income Tax Returns, Table 2.1.

After exemptions for taxpayers themselves (includes taxpayer and taxpayer's spouse), exemptions for children are the largest percentage of personal and dependent exemptions—31.37 percent.

Table 2 lists the total number of exemptions claimed on Federal tax returns, the number of exemptions for children, and the number of exemptions for children as a percent of all exemptions by adjusted gross income class for tax year 1982. The number of exemptions for children as a percent of total exemptions ranged from a low of 18.82 percent for the adjusted gross income class of $1 under $5,000, to a high of 38.44 percent for those with adjusted gross income (AGI) between $30,000 and $40,000. Exemptions for children were a steadily increasing portion of all exemptions through the $30,000 to $40,000 level of AGI. After this adjusted gross income class, the number of exemptions for children as a percent of all exemptions declined to 28.62 percent at an AGI of $1 million or more.

Table 3 provides data on the number of exemptions for children at home and away from home, total exemptions for children, and the percent distribution of total exemptions for children by adjusted gross income class. In tax year 1982, 6.6 percent of the exemptions for children were claimed on tax returns with adjusted gross incomes below $5,000. Taxpayers in the adjusted gross income classes between $5,000 and $20,000 claimed 36.7 percent of the exemptions for children. Taxpayers in the adjusted gross income classes between $20,000 and $40,000 claimed 40.3 percent of the exemptions for children. Finally, taxpayers in the adjusted gross income classes over $40,000 claimed 15.3 percent of the exemptions for children.

TABLE 2.—TOTAL PERSONAL EXEMPTIONS AND EXEMPTIONS FOR CHILDREN, TAX YEAR 1982

Size of adjusted gross income	Number of returns	Number of exemptions	Number of exemptions for children	
			Amount	As a percent of total exemptions claimed
Total	95,337,432	232,191,565	72,823,582	31.36
$1 under $5,000	17,041,100	25,524,700	4,803,111	18.82
$5,000 under $10,000	17,039,853	34,544,133	8,614,134	24.94
$10,000 under $15,000	14,306,781	33,236,240	9,786,373	29.44
$15,000 under $20,000	10,534,728	26,572,598	8,325,761	31.21
$20,000 under $25,000	8,803,387	24,398,217	8,580,264	35.17
$25,000 under $30,000	7,621,965	22,930,409	8,513,396	37.13
$30,000 under $40,000	9,862,616	31,879,568	12,254,869	38.44
$40,000 under $50,000	4,716,532	15,530,458	5,721,895	36.84
$50,000 under $75,000	3,057,266	10,084,987	3,631,859	36.01
$75,000 under $100,000	702,064	2,376,868	855,290	35.98
$100,000 under $200,000	570,839	1,997,721	724,164	36.25
$200,000 under $500,000	140,278	485,934	161,874	33.31
$500,000 under $1,000,000	20,681	68,480	19,988	29.19
$1,000,000 or more	8,408	27,759	7,945	28.62

Source: U.S. Department of the Treasury. Internal Revenue Service. 1982 Statistics of Income, Individual Income Tax Returns. Washington, 1983. Table 2.3, p. 63.

TABLE 3.—NUMBER OF RETURNS OF NUMBER OF EXEMPTIONS FOR CHILDREN BY SIZE OF ADJUSTED GROSS INCOME, TAX YEAR 1982

Size of adjusted gross income	Exemptions for children				Total exemptions for children		
	At home		Away from home				
	Number of returns	Number of exemptions	Number of returns	Number of exemptions	Number of returns	Number of exemptions	Percent of total exemptions for children
Total	35,900,857	70,552,866	1,517,498	2,270,716	37,418,355	72,823,582	100.00
No adjusted gross income	375,843	798,804	13,812	23,855	389,655	822,659	1.13
$1 under $5,000	2,657,195	4,699,327	80,126	103,784	2,737,321	4,803,111	6.60
$5,000 under $10,000	4,376,838	8,394,606	162,443	219,528	4,539,281	8,614,134	11.83
$10,000 under $15,000	4,933,967	9,506,267	190,389	280,106	5,124,356	9,786,373	13.44
$15,000 under $20,000	4,132,650	8,093,003	156,285	232,758	4,288,935	8,325,761	11.43
$20,000 under $25,000	4,166,833	8,226,357	219,714	353,907	4,386,547	8,580,264	11.78
$25,000 under $30,000	4,083,356	8,184,290	219,453	329,106	4,302,809	8,513,396	11.69
$30,000 under $40,000	3,854,052	11,931,552	222,341	323,317	6,076,393	12,254,869	16.83
$40,000 under $50,000	2,772,030	5,540,282	113,363	181,613	2,885,393	5,721,895	7.86
$50,000 under $75,000	1,762,404	3,491,610	89,723	140,249	1,852,127	3,631,859	4.99
$75,000 under $100,000	384,000	816,355	25,394	38,935	409,394	855,290	1.17
$100,000 under $200,000	318,307	687,170	20,275	36,994	338,582	724,164	0.99
$200,000 under $500,000	70,053	156,733	3,313	5,141	73,366	161,874	0.22
$500,000 under $1,000,000	8,977	18,979	613	1,009	9,590	19,988	0.03
$100,000,000 or more	3,453	7,531	254	414	3,707	7,945	0.01

Source: U.S. Department of the Treasury. Internal Revenue Service. 1982 Statistics of Income, Individual Income Tax Returns. Washington, 1983. Table 2.3, p. 63.

II. THE CHILD AND DEPENDENT CARE TAX CREDIT

The child and dependent care tax credit is a nonrefundable income tax credit which is allowed to a taxpayer who pays employment-related child and dependent care expenses, and who maintains a household for one or more qualifying individuals. The credit, enacted by the Tax Reform Act of 1976 (P.L. 94-455), replaced the previous provision for an itemized deduction for child and dependent care expenses. Congress felt that the itemized deduction was unduly restricted because of its complexity and its restriction to only those taxpayers who itemized their tax returns.[3]

As defined, a qualifying individual is an individual who is: (1) under the age of 15 and for whom the taxpayer may claim a dependency exemption; or (2) a physically or mentally incapacitated dependent or spouse who is incapable of caring for himself or herself. Employment-related expenses are those expenses incurred to enable the taxpayer to work or to look for work. They include expenses for both household services and expenses for the care of the qualifying individual.

The amount of employment-related expenses eligible for the credit is subject to both a dollar limit and an earned income limit. Expenses are limited to $2,400 for one qualifying individual and $4,800 for 2 or more qualifying individuals. They cannot exceed the earned income of the taxpayer, if single, or if a married couple, the earned income of the spouse with the lower earnings. In addition, the married couple must file a joint return to claim the credit. The amount of the credit that a taxpayer may apply to these employment-related expenses is based upon the earned income of the taxpayer. The tax credit is based on a sliding scale of 30 percent to 20 percent, declining as income increases from $10,000 to $28,000. In other words, if the taxpayer's income is $10,000 or less, he or she may claim 30 percent of their employment-related expenses. For each increase of $2,000 in AGI, the amount of the credit declines one percentage point up to $28,999 of AGI and above when the tax credit is 20 percent of allowable expenses. Table 4 below summarizes the relationship between the adjusted gross income level and the tax credit.

TABLE 4.—THE CHILD AND DEPENDENT CARE TAX CREDIT: AMOUNT OF ADJUSTED GROSS INCOME AND RELATED TAX CREDIT APPLICABLE

	Tax credit rate (percent)
Adjusted gross income:	
Less than $10,000	30
$10,000 under $12,000	29
$12,000 under $14,000	28
$14,000 under $16,000	27
$16,000 under $18,000	26
$18,000 under $20,000	25
$20,000 under $22,000	24
$22,000 under $24,000	23
$24,000 under $26,000	22
$26,000 under $28,000	21
$28,000 or more	20

Table 5 provides data on the distribution of child and dependent care credit by adjusted gross income for tax year 1982. The credit was claimed on 5.25 percent of the 95,337,432 returns filed in 1982 and 6.19 percent of the 77,035,300 of taxable returns filed. For taxable returns, 30 percent of the total amount claimed for the tax credit was claimed on returns with adjusted gross incomes below $20,000, 50 percent was claimed on returns with adjusted gross incomes between $20,000 and $40,000, and 19 percent was claimed on returns with adjusted gross incomes between $40,000 and $75,000.

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[3] U.S. Congress. Joint Committee on Taxation. General Explanation of The Tax Reform Act of 1976. (H.R. 10612, 94th Congress, Public Law 94-455). p. 124.

TABLE 5.—DISTRIBUTION OF THE CHILD CARE CREDIT BY ADJUSTED GROSS INCOME CLASS, TAX YEAR 1982

[Dollars in thousands]

	All returns			Taxable returns		
	Number of returns	Amount	Percent of total	Number of returns	Amount	Percent of total
All returns—Total	5,003,639	$1,501,453		4,764,879	$1,432,749	
Under $5,000	[1] 10,702	[1] 963	(2)	[1] 718	[1] 129	(2)
$5,000 under $10,000	280,328	73,676	4.91	118,438	30,091	2.10
$10,000 under $15,000	581,065	210,194	14.00	527,505	188,902	13.18
$15,000 under $20,000	642,705	203,165	13.53	638,910	202,093	14.11
$20,000 under $25,000	772,760	221,213	14.73	767,504	220,642	15.40
$25,000 under $30,000	649,448	176,069	11.73	645,190	174,721	12.19
$30,000 under $40,000	1,124,671	320,477	21.30	1,124,671	320,477	22.37
$40,000 under $50,000	604,349	184,486	12.29	604,349	184,486	12.88
$50,000 under $75,000	274,891	88,324	5.89	274,891	88,324	6.16
$75,000 under $100,000	37,068	12,142	0.81	37,068	12,142	0.85
$100,000 under $200,000	21,923	8,832	0.59	21,906	8,829	0.62
$200,000 under $500,000	3,351	1,702	0.11	3,351	1,702	0.01
$500,000 under $1,000,000	269	145	(2)	269	145	(2)
$1,000,000 or more	109	65	(2)	109	65	

[1] Estimate based on a small number of sample returns.

[2] Less than 0.01 percent.

Source: U.S. Department of the Treasury. Internal Revenue Service. 1982 Statistics of Income, Individual Income Tax Returns. Washington, 1983. Table 3.3, p. 81.

The maximum amount of the tax credit is $720 for one qualifying individual and $1440 for two or more qualifying individuals.

Table 6 lists the average amount of the child and dependent care tax credit claimed by adjusted gross income class. The average tax credit amount claimed for all returns was $300. For taxable returns, the amounts ranged from $180 for returns with adjusted gross incomes below $5,000 to $596 for returns with adjusted gross incomes of $1,000,000 or more.

TABLE 6.— AVERAGE CHILD AND DEPENDENT CARE CREDIT CLAIMED PER TAX RETURN BY ADJUSTED GROSS INCOME CLASS

	All returns	Taxable returns
Total	$300.7	$300.69
Under $5,000	89.98	179.66
$5,000 under $10,000	262.82	254.06
$10,000 under $15,000	361.74	358.10
$15,000 under $20,000	316.11	316.31
$20,000 under $25,000	286.26	287.48
$25,000 under $30,000	271.11	270.81
$30,000 under $40,000	284.95	284.95

TABLE 6.— AVERAGE CHILD AND DEPENDENT CARE CREDIT CLAIMED PER TAX RETURN BY ADJUSTED GROSS INCOME CLASS—Continued

	All returns	Taxable returns
$40,000 under $50,000	305.28	305.28
$50,000 under $75,000	321.31	321.31
$75,000 under $100,000	327.56	327.56
$100,000 under $200,000	402.86	403.04
$200,000 under $500,000	507.91	507.92
$500,000 under $1,000,000	539.03	539.03
$1,000,000 or more	596.33	596.33

III. The Earned Income Class

The earned income credit is a refundable income tax credit that is avaliable to low-income workers who maintain households in which children reside. Earned income, the basis for the credit, is defined as wages, salaries, tips, and other employee compensation plus any net earnings from self employment. The credit against income tax liability is equal to 10 percent of the first $5,000 of earned income. The maximum credit of $500 is reduced by an amount equal to 12.5 percent of the excess of AGI or earned income (whichever is greater) over $6,000. The credit phases out when either AGI or earned income reaches $10,000.

In tax year 1985, the earned income credit is increased to 11 percent of the first $5,000 of earned income. The maximum credit of $550 is reduced by an amount equal to 12⅛ percent of the excess of adjusted gross income or earned income over $6,500. The credit phases out when earned income reaches $11,000.

Table 7 lists the number of returns and the total amount of money claimed under the earned income tax credit.

TABLE 7. DISTRIBUTION OF THE EARNED INCOME CREDIT BY ADJUSTED GROSS INCOME CLASS, TAX YEAR 1982

[Percent Dollars in Thousands]

	Number of returns	Amount	Number of taxable returns	Amount
All returns—Total	2,698,238	$359,727	1,349,946	$183,616
Under $5,000	149,402	8,561	[1] 1,351	[1] 488
$5,000 under $10,000	2,548,836	351,166	1,348,595	183,128

[1] Estimate based on a small number of sample returns.

Source: U.S. Department of the Treasury, Internal Revenue Service. 1982 Statistics of Income, Individual Income Tax Returns. Washington, 1985. Table 3.3, p. 81.

TAX REFORM AND THE FAMILY*

Geraldine Gerardi and Eugene Steuerle**

INTRODUCTION

In response to the public's dissatisfaction with the current tax system, Congress introduced almost two dozen bills in the 98th Congress to reform and simplify the income tax. Since the 99th Congress convened in January, a similar number of tax reform and simplification bills have been introduced. The growing interest in major tax reform has focused attention on such family issues as whether the combined income of a married couple or the income of each spouse should be taxed, how tax burdens should be adjusted for family size, and whether the special circumstances of single persons with dependents and two-earner married couples should be recognized. These issues, which are central in the design of a tax system, are some of the most difficult tax policy issues to resolve. Widely accepted objectives for tax reform often provide conflicting guidance on the appropriate tax treatment.

The purpose of this paper is to set forth the objectives of tax reform that relate to the tax treatment of the family and to show how they are addressed in designing a major tax reform proposal. For illustrative purposes, some examples will use the 1984 tax reform proposals of the Treasury Department, and the Bradley-Gephardt and the Kemp-Kasten proposals as they were outlined on January 1, 1985. Although some of these proposals have changed and may continue to change, they can be used to illustrate the trade-offs that have to be considered in a major tax reform effort.

OBJECTIVES OF TAX REFORM

Tax reform generally has been guided by the following objectives: (1) equity, (2) economic neutrality, and (3) simplicitly.

EQUITY

Most of the issues in the tax treatment of the family are issues of equity. The basic notions of equity that underlie our tax system are twofold: equal treatment of equals and progressivity. Equal treatment of equals implies that those with similar ability to pay tax should pay about the same amount of tax. Although there are alternative definitions of progressivity, the most common definition is that the average tax rate should increase as income increases, i.e., those with higher incomes should pay a higher fraction of their incomes in taxes.

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*EDITOR'S NOTE.—Since this paper was originally prepared, significant changes have been made in a number of the tax proposals that are reviewed. Significant among these have been changes in the Earned Income Tax Credit and the Zero Bracket Amount in the Kemp-Kasten plan. The President's tax proposal also differs from the Treasury report in such items as the Earned Income Tax Credit. The authors tried to emphasize throughout how choices in the taxation of families would be made rather than detailed comparisons of proposals that were, and in some cases still are evolving.

**Office of Tax Analysis, Department of the Treasury. The views expressed in this paper are those of the authors and do not necessarily reflect those of the Department of the Treasury.

Although progressivity as an objective has widespread support, it is the source of a number of fundamental conflicts in the tax treatment of the family. Most of these conflicts center around the choice of the taxpaying unit. For example, if the couple is the tax unit, as under the existing progressive tax, a married couple in which each spouse earns $25,000 will have a higher tax bill than the combined tax bill of two single persons earning $25,000 each. On the other hand, under current law a single worker will pay more tax on a given income than a married worker with no children and a spouse with no earnings, regardless of the ability of that spouse to work outside the home. Since it is impossible to tax families with equal income equally and to tax individuals with equal incomes equally, many persons' notions of equal treatment of equals will be violated under a progressive tax system. Yet, solving one problem will generally aggravate the other.

Such issues go away if progressivity is abandoned. Under a single-rate flat tax with no exempt amount of income (such as that provided by personal exemptions and zero bracket amounts), income would be taxed equally regardless of how it is split among family members. Because the allowance of an exempt amount of income provides some progressivity, however, these issues are not avoided through the adoption of what has come to be known as a flat tax; a tax with one zero tax rate and one positive tax rate. Moreover, the adoption of either a single-rate flat tax or a two-rate flat-rate tax would raise other equity issues, because tax burdens would be redistributed from high-income taxpayers to low-and middle-income taxpayers.[1]

Once progressivity is accepted as an objective, the issues for tax reform are to determine: (1) the appropriate unit of taxation: the individual, the household, or the family; (2) the relative burdens of single persons and married couples with the same incomes; (3) the relative tax burdens of married couples with equal incomes but different splits of income between the spouses; (4) the adjustment of tax burdens for the presence of children and other dependents; and (5) the treatment of poor families under the income tax.

The tax unit.—In deciding the issue of equal treatment of equals, or horizontal equity, with respect to the tax unit, equals may be defined in terms of 1) individuals, 2) households without regard to the marital status of the adults, or 3) identifiable family groups. One view is that the household should be the unit of taxation without regard for the marital status of the adults in that household.[2] The rationale for this view is that income is pooled and consumption is shared; therefore, an individual's welfare depends not only on his or her own income but also on the aggregate income of the household.

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[1] See Chapoton (1982) and Department of the Treasury (1984).

[2] For example, see McIntyre and Oldman (1977).

The problem with imposing the tax on household income, however, is that it would create incentives for individuals arbitrarily to form households in some cases and to conceal such living arrangements in others. Pooling of income takes place in a wide variety of situations, such as when single individuals live together in dormitories or in group homes for the elderly. To minimize the problem of the government determining which living arrangements involve pooling of resources, the traditional approach, which is the one used in current law, is to recognize the marital unit as the only major identifiable grouping of adults for which adjustments are made to account for pooling of income and consumption.

An alternative view of the appropriate tax unit is that every individual would be treated alike.[3] According to this view, horizontal equity requires that the tax laws be neutral with respect to marital status. Proponents of individual taxation argue that it is consistent with social trends, such as the incresing number of women who participate in the labor force and of people who choose a life style that does not include marriage. Under this approach, persons with equal incomes would pay about the same amount of tax without regard to the income of spouses. If an individual married or became single, it would not affect his or her tax liability.

However, individual taxation ignores the fact that families generally pool their resources and that combined resources are a better measure of ability to pay.[4] Individual filing also would recreate some inequities that joint filing redressed. Joint filing was allowed under the federal income tax largely to allow couples living in states without community property laws the same tax advantages as couples living in states with community property laws. In community property states, one-half of a married couple's combined income was attributed to each spouse for tax purposes, regardless of the proportion of income actually generated by each spouse. In cases where one spouse actually accounted for all or most of the couple's income, income splitting allowed the couple to pay less in federal taxes than would be paid by a couple with the same income in a non-community property state. Moreover, individual taxation would not recognize that some income splitting would occur regardless of the federal treatment of state community property laws. A couple could alter its tax burden by redistributing property ownership between the spouses.

Although individual taxation generally would insure that a couple's taxes would not increase when they marry, couples with equal incomes would not necessarily pay the same amount of tax. For example, a one-earner couple with the worker holding two jobs would pay more tax than a two-earner couple with the same combined income.

Marriage penalties, divorce bonuses, single penalties, and marriage bonuses.—Some would argue that under a fair income tax two single persons should not pay a higher tax when they marry (i.e., that there should be no "marriage penalty"), and, on the other hand, that a couple should not have its taxes reduced when the partners divorce and become single again (no "divorce bonus"). Also, a single person should not have to pay a higher tax than a one-earner married couple with equal income (no "single penalty") or, similarly, tax burdens should not decline substantially simply because of marriage (no "marriage bonus").

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[3] For example, see Brazer (1980) and Munnell (1980). Some state tax laws also use the individual approach.

[4] Recognition of pooling of resources is also intergral to the design of welfare and social security systems, as well as the tax system.

Once the family or couple is accepted as the unit of taxation, however, conflicts arise. Under a progressive income tax it is impossible to tax equally both all families with equal incomes and all persons with equal incomes. For example, if the goals of progressivity and taxing families on the basis of their total family income are given precedence, reducing the marriage penalty would exacerbate the single penalty.

An added complication: Imputed income.—Although a widely accepted goal of tax policy is to tax married couples with equal incomes the same, some argue that it is inequitable for married couples to pay the same tax whether there are two earners or one. The household with one earner may have greater ability to pay, because the spouse who does not work outside the home in effect produces income ("imputed income") by providing household services. The comparison with two-earner couples becomes more obvious when the latter pay for household services similar to those that might be provided by a spouse who works in the home, or when they pay for the additional non-deductible expenses associated with two jobs.

Probably, no satisfactory solution to this problem exists. In principle, the problem could be solved by taxing the imputed income from household production.[5] In practice, it is difficult to measure this income and taxing it would be unlikely to have widespread public support. Alternatively, certain deductions could be allowed for the additional expenses incurred by two-earner couples, but these deductions would increase the complexity of the tax law.

Adjustments for family size.—A number of considerations influence the way families of different size are treated under the income tax.[6] If assisting families is a particular objective, a tax adjustment for dependents should be designed to ensure some minimum level of well-being for each dependent. To meet this objective, a credit may be a more appropriate allowance than an exemption because credits will grant equal relief for each additional dependent.

Another justification for making allowance for family size is based upon ability to pay. According to this view, a fair income tax should take into account the effect of family size on ability to pay: given equal pre-tax incomes, a family of six has less ability to pay than a family of three. It is argued that families with equal before-tax standards of living should be able to maintain equal after-tax standards of living.

One complication with applying the ability to pay principle to the taxation of families is that in effect income is spent on or is transferred to dependents. The question is whether such transfers should be taxed at the tax rate of the transferor (often high) or the transferee (often low). One view is that the transferor should pay the taxes on this income, because the entity earning the income should pay the taxes. This view stresses the sources rather than the uses of income. Another view is that the transferee should be taxed, because the transferee enjoys or consumes the income. This view stresses the uses rather than the sources of income. Alternatively, if the family is viewed as a unit which shares income and consumption, the income of all family members should be aggregated and taxed at the applicable tax rate. In this case, income splitting among household members may be required in order to define equal levels of consumption or of ability to pay among families of different sizes.

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[5] Rosen argues that differential taxation of time spent in the home and in the market place is necessary for efficient tax treatment, because supply elasticities differ for home and market production. See Rosen (1976), p. 17.

[6] See Steuerle (1983).

Tax treatment of the poor.—One commonly accepted objective of tax reform is to ensure that families with incomes at or below the poverty level are not subject to income tax. The rationale for this exemption is that individuals with incomes below the subsistence level do not have ability to pay income taxes. To the extent that the taxation of income below the subsistence level deprives low-income families of the resources they need to provide basic necessities, it would reduce the health, education, and efficiency of the labor force.[7] Thus, taxation could reduce productivity and increase other public expenditures for social welfare programs.

Tax-exempt income levels for single persons and families of different sizes could be based on official poverty thresholds, as determined by the Bureau of the Census. Poverty thresholds, however, also recognize the benefits that come from pooling income and resources. Thus, if tax-exempt income levels were determined by strict adherence to poverty income measures, marriage penalties would result.

For example, the 1986 poverty thresholds are estimated to be $5,800 for single persons without dependents and $7,400 for married couples. If the tax-free income levels were set at the poverty levels, a single person with income of $5,800 or less and a married couple with income of $7,400 or less would not pay taxes. A marriage penalty would occur when some single persons with income marry, because their combined tax-exempt income level would fall. If two single persons with incomes of $5,800 married, their combined income for tax purposes would be $11,600, which is $4,200 above the poverty threshold for a married couple. As single individuals, neither partner would have paid taxes. As a married couple, however, they would owe taxes on the $4,200 of income that exceeded the poverty threshold.

Under a rule matching tax exempt income levels and poverty thresholds, the tax-exempt income level would increase if certain married couples with children separated into two families each headed by a single person. For example, the 1986 poverty thresholds for a married couple with two children and for a single person with one child are estimated to be $11,600 and $7,900, respectively. On an income below $11,600, the married couple with two children would pay no taxes. Should that couple divorce and create two families, each with one child, each family's income below $7,900 would not be subject to tax. For the two families combined, this amounts to an increase of $4,200 in their tax exempt level (($7,900 × 2) − $11,600 = $4,200).

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[7] See Seltzer (1968).

If poverty thresholds were used to adjust accurately for the presence of dependents, additional complexity would occur. According to the poverty measures, the financial needs of a household do not increase by the same amount for each additional household member. Thus, in principle, the tax-exempt amount for each additional dependent (as determined by the dependent exemption) would be different, depending upon the number of family members in the household.[8] Calibrating the tax-exempt income level so precisely would be complex. If the dependent exemption were kept constant, it would be too high or too low for many families even when the tax-exempt level matches the poverty level for a family of one given size.

ECONOMIC NEUTRALITY

Although equity issues are the focus of most discussions of taxation of the family, other goals of tax reform, such as economic neutrality, are also important. An ideal tax system would be as neutral as possible toward private decisions, i.e., it would not unnecessarily influence or distort the choices about how income is earned and how it is spent. No tax can be completely neutral, however, because it affects the choice between work and leisure, consumption and saving, and safe and risky investments.

The choice of the tax unit affects economic neutrality of the income tax. A progressive tax on the combined income of the couple is inefficient, because the second earner generally faces higher marginal tax rates than a single person or the "first" earner. As a result, tax considerations may distort decisions about labor market entry, choices among occupations, and investment in education.

On neutrality grounds, the marginal tax rate—the rate that applies to an additional dollar of income—should be the lowest where it affects behavior the most. This implies that the marginal rate on second earners (typically wives) should be lower than the rate for married men or single persons regardless of the unit of taxation chosen, because married women have more discretion over their labor market activity.[9]

By reducing the financial return from working, high marginal tax rates decrease the labor force participation rate of married women and the number of hours worked. However, these distortions would be reduced if the individual were the tax unit, because marginal tax rates on second earners would be the same as for other workers.

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[8] For example, the poverty threshold is estimated to increase in 1986 by $1,700 when a single person marries, by $1,543 when one child is added to the family, $2,384 when a second child is added, and $2,042 when a third child is added.

[9] See Boskin (1980).

SIMPLICITY

The third objective of tax reform is to simplify the income tax and thereby reduce compliance costs and enhance the perception of equity of the tax system. A simpler income tax would relieve most taxpayers from spending a great deal of time wading through complex instructions or from having to hire professional help to prepare their tax returns. It would also reduce recordkeeping requirements for most taxpayers. A simpler income tax would also reduce costs and ease administration of the income tax for the government.

A simpler income tax also may be perceived to be fairer by many taxpayers. Some taxpayers suspect that others with the same incomes are paying less taxes. because they have better knowledge of ways to avoid taxes and greater ability to manipulate legal loopholes in existing law.

However, simplicity may conflict with other objectives of tax reform. For example, equity may require deductions for certain catastrophic medical expenses, which affect ability to pay. However, the allowance of such deductions complicates tax filing.

RESOLUTION OF CONFLICTING OBJECTIVES

Not all of the desirable objectives of tax reform can be achieved simultaneously. Thus, designing a tax reform program requires trade-offs among competing objectives. This section describes some of the trade-offs that affect the tax treatment of the family under tax reform. Examples from three major tax reform proposals are used to illustrate how compromises are made—the Treasury Department's 1984 proposal, the Bradley-Gephardt proposal, and the Kemp-Kasten proposal, as they were outlined on January 1, 1985.

THE TAX UNIT

Under a progressive tax system, a satisfactory solution to the issue of whether married couples should file jointly or as individuals probably does not exist. The major tax reform proposals keep the married couple as the tax unit. Although arguments in favor of individual filing have merit, administrative considerations, as much as any other factor, probably force the decision to retain joint filing with some income splitting. If individuals filed separately on the basis of earned income, arbitrary rules would be required to attribute unearned income and to allocate deductions between the spouses. Since married couples are able to split property income and income in a closely-held business, joint filing prevents differences in tax burdens across families from depending on each family's ability to transfer income between spouses.

Nonetheless, retaining the married couple as the tax unit leaves many of the problems discussed before. For example, it is necessary to deal with the marriage penalty. As discussed below, most major tax reform proposals try to reduce or eliminate such marriage penalties through adjustments in the tax threshold or in the tax rate schedules.

Whether the individual or the couple is chosen as the tax unit, how to handle the imputed income of individuals who do not work outside the home remains a problem. As noted earlier, the practical problems of taxing imputed income are formidable. None of the major tax reform proposals provide adjustments that recognize differences in ability to pay attributable to imputed income.

THE LEVELS OF THE ZBA AND PERSONAL EXEMPTIONS

The zero bracket amount [ZBA] and personal exemptions perform several very important functions: (1) they establish the tax-exempt income level, i.e., the level of income below which no income tax is owed; (2) they provide (or increase) graduation in effective tax rates at the lower end of the income scale; (3) the ZBA simplifies the income tax by reducing the number of taxpayers who itemize deductions; and (4) the personal exemptions differentiate among households according to the number of dependents.

Under the three proposals the levels of the ZBA and personal exemptions have been set so that families with income at or below the poverty line generally would not pay income tax. The personal exemptions and ZBAs under current law and the three proposals are shown on Table 1. Under the Treasury Department and Kemp-Kasten proposals the personal exemptions would increase from $1,090 (the estimated 1986 level) to $2,000. Under the Bradley-Gephardt proposal, the personal exemption would be $1,600 for the taxpayer and spouse, $1,800 for a head of a household, and $1,000 for dependents.

Table 1 also shows the increases in the ZBAs under the three proposals. The Bradley-Gephardt and Kemp-Kasten proposals would allow heads of households the same ZBA as single persons with no dependents—the approach taken by current law. In contrast, the Treasury Department's proposal provides heads of households with a ZBA that is approximately one-half way between the ZBAs for single returns and joint returns. The Bradley-Gephardt proposal departs from current law and the other proposals by providing joint returns with a ZBA that is twice the ZBA for single returns.

Table 2 compares the tax thresholds under current law and selected tax reform proposals with estimated poverty thresholds for single persons and families of different sizes for 1986. Under current law the tax threshold is too low to exempt from taxation the poverty level incomes of single persons and married couples with and without dependents. Under the Treasury Department and other major tax reform proposals, the tax thresholds for families of all sizes are close to the poverty level even without the earned income credit (discussed below). With the earned income credit, tax exempt levels for households and families with dependents exceed poverty income levels.

TABLE 1.—COMPARISON OF PERSONAL EXEMPTION AND ZBA UNDER CURRENT LAW AND SELECTED TAX REFORM PROPOSALS AS OF JANUARY 1, 1985

	1986 levels			
	Current law [1]	Treasury Department	Bradley-Gephardt	Kemp-Kasten
Personal exemption:				
Taxpayer and spouse	$1,090	$2,000	[2] $1,600	$2,000

BLE 1.—COMPARISON OF PERSONAL EXEMPTION AND ZBA UNDER CURRENT LAW AND SELECTED TAX REFORM PROPOSALS AS OF JANUARY 1, 1985—Continued

	1986 levels			
	Current law [1]	Treasury Department	Bradley-Gephardt	Kemp-Kasten
Dependents (each)	1,090	2,000	1,000	2,000
Zero bracket amount:				
Single returns	2,510	2,800	3,000	2,600
Joint returns	3,710	3,800	6,000	3,300
Head of household returns	2,510	3,500	3,000	2,600

[1] Includes indexation for expected inflation in 1985.

[2] $1,800 for heads of households.

TABLE 2.—COMPARISON OF POVERTY THRESHOLD AND TAX-FREE INCOME LEVEL UNDER CURRENT LAW AND SELECTED TAX REFORM PROPOSALS AS OF JANUARY 1, 1985

	Poverty threshold	Tax-free income levels [1]			
		Current law	Treasury Department	Bradley-Gephardt	Kemp-Kasten [2]
Single persons without dependents	$5,800	$3,600	$4,800	$4,600	$5,750
Heads of households with one dependent	7,900	7,979	9,303	8,225	8,250
Married couples [3]	7,400	5,890	7,800	9,200	9,125
Married couples with two dependents [3]	11,600	9,613	11,800	11,200	14,125

[1] Includes expected indexation for inflation in 1985 where applicable. Assumes full use of the earned income credit where applicable.

[2] Includes 20 percent exclusion for employment income.

[3] Assumes one earner.

There is one exception to the general rule: under the three tax reform proposals, the tax threshold for single persons is below the poverty threshold. The relatively low tax threshold for single persons reflects another compromise between competing objectives of tax reform—tax exemption for poverty income levels, reduction of the marriage penalty, and avoidance of a large single penalty. If the ZBA were to be increased so that the tax threshold for all returns exactly equalled the poverty threshold, those who decided to marry would experience a significant increase in tax (marriage penalty). However, if the single tax threshold were set exactly at the poverty level and the marriage penalty was avoided, the revenue cost would increase significantly and the single penalty would become quite large.

For example, given a personal exemption of $2,000 the ZBA for single returns would have to be increased to $3,800 to raise the tax-free income level to the poverty threshold. Alternatively, if the tax exempt level for joint returns were set at the poverty level and the marriage penalty were eliminated, the ZBA for single returns would have to be reduced to $1,900. The ZBA for single returns under the Treasury Department's proposal is almost in the middle of the ZBAs under these two alternatives.

Setting the tax-exempt income level below the poverty threshold may also be justified because many single persons live with relatives or other unrelated individuals. If the tax-exempt income level for these individuals is combined with the tax-exempt income levels of other members of the household, the total may exceed the poverty threshold. Approximately one-quarter of all single returns with income subject to tax are filed by persons who are under 21 years of age.[10] In many cases, the tax-exempt income levels of these individuals should be combined with the tax-exempt income level of parents and other members of the household in order to reflect accurately the tax-exempt income for the family. Similarly, a correctly measured poverty level for two single persons who share living quarters may be close to that of a married couple, but their combined tax-exempt level under the Treasury Department's proposal exceeds the poverty level.

Unlike current law and the Treasury Department and Kemp-Kasten proposals, the Bradley-Gephardt proposal tackles the problem of the marriage penalty that is attributable to the ZBA by setting the joint return ZBA at twice the level for single returns. As a result, tax-exempt levels of income for joint filers with no or few dependents are well in excess of the poverty level. However, the tax-exempt level for couples with two or more dependents falls short of the poverty threshold, because the adjustment (exemption) for dependents is relatively low.

In the past, one major objective of increasing the ZBA (formerly called the standard deduction) was to simplify tax filing by reducing the number of itemizers. Under the major tax reform proposals, however, this simplicity argument is less compelling. Because the proposals would limit itemized deductions, the number of itemizers would decline anyway.

The fourth objective—adjusting for household size—is achieved primarily through changes in the personal exemption. Using poverty income measures as a guide, the estimated increases in the poverty threshold vary as family size increases. On average, the 1986 poverty levels are estimated to increase by approximately $1,900 each for the first four additional members of a household.

If an exemption of approximately $1,900 is chosen to adjust for household size and if targeting poverty thresholds is an objective, however, very little leeway is allowed for adjustments to the zero bracket amounts.[11] Alternatively, the level of the personal exemptions could be reduced and different ZBA's for different sizes of households could be provided, but this would increase the number of rate schedules.

Current law, the Treasury Department's proposal, and the Kemp-Kasten proposal take the approach of providing the taxpayer the same level of personal exemption as dependent exemption. The Bradley-Gephardt proposal would allow a larger exemption for the taxpayer and spouse than for dependents. The large increase in the ZBA for joint returns also may be viewed as adjustment for the presence of dependents.

THE RATE SCHEDULES

Under current law, personal income taxes are imposed under four different rate schedules: 1) married persons filing separate returns, 2) married persons filing joint returns and surviving spouses, 3) single returns, and 4) head of household returns. There are 14 taxable brackets (15 for single returns). The rates range from 11 percent for the first taxable income bracket above the ZBA to 50 percent for the top bracket.

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[10] See U.S. Department of the Treasury (1984), p. 69.

[11] The poverty thresholds for a single person with no dependents and a married couple with no dependents are estimated to be $5,800 and $7,400, respectively. If the personal exemption is set at $1,900, the ZBA would have to be set at $3,900 for single returns and $3,600 for joint returns in order to track the poverty thresholds.

The Treasury Department, Bradley-Gephardt, and Kemp-Kasten proposals retain the four filing units of current law. However, the 14 or 15 rate brackets above the zero rate bracket are collapsed into a smaller number of brackets. Under the Treasury Department's proposal, there would be three taxable brackets with rates that range from 15 percent for the first taxable income bracket to 35 percent for the top bracket. The Bradley-Gephardt proposal also has three taxable brackets with rates that range from 14 percent for the first taxable income bracket to 30 percent for the top bracket. Although the Kemp-Kasten proposal would tax income at the rate of 24 percent, various deductions and additions in effect create several rates.[12]

The principal family issue to be decided in setting rate schedules is the relationship between the tax burdens of single persons and married couples. Along with the setting of the ZBA—which can be viewed as the first bracket in a rate schedule—this relationship generally determines the balance between single penalties, marriage penalties, divorce bonuses, and marriage bonuses.

If the bracket width (the amount of income taxed at a given rate) for joint returns is set at 200 percent of the bracket width for single returns, no marriage penalty arises from the rate schedules, but the single penalties and marriage bonuses become quite large. If the bracket width for joint returns is set at 100 percent of the bracket width for single returns, the marriage penalties and the divorce bonuses increase.

Under current law, the relationship among the rate schedules reflects a series of adjustments that were made over time. No readily identifiable rule prevails. Under the Treasury Department's proposals the bracket widths for joint returns is approximately 170 percent of the widths for single returns. The Treasury proposal would eliminate marriage penalities due to the rate schedules for most two-earner couples, because earnings generally are split less evenly than assumed by the bracket widths.[13] Under the Bradley-Gephardt proposal the bracket widths for joint returns are approximately 200 percent of the widths for single returns. Therefore, it virtually eliminates the marriage penalties due to the rate schedules.

Under current law, a special deduction is provided for a portion of the earnings of a second spouse. However, this deduction is poorly targeted. For many married couples the deduction reduces, but does not eliminate, the marriage penalty. Moreover, it increases the marriage bonus for many married taxpayers who have never suffered from a marriage penalty. In addition, by violating the objective that married couples with equal income should pay the same amount of tax, the deduction means higher taxes for the family where two jobs are held by one spouse than for the family where two jobs are held by two spouses.

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[12] In addition to the ZBA and personal exemptions, Kemp-Kasten provides an exclusion for 20 percent of earned income up to the FICA wage base. Above the FICA wage base, 20 percent of gross income is added back. The effect of the exclusion is to tax wage income below the FICA maximum at an effective rate of about 19.2 percent. Income above the FICA maximum is taxed at an effective rate of approximately 28.8 percent.

[13] For approximately 45 percent of joint returns with two wage earners in 1979 the spouse with the lower earnings accounted for less than 25 percent of combined wages. (Unpublished data from the Internal Revenue Service).

The Treasury Department's proposal reduces the marriage penalty by flattening the rate schedules and setting the bracket widths as indicated; the two-earner deduction would be repealed. Similarly, the Bradley-Gephardt and Kemp-Kasten proposals would reduced marriage penalties by flattening the rate schedules; they would also repeal the two-earner deduction.

Another view of the two-earner deduction is that it is a way of addressing the imputed income problem. If this view is accepted, however, single individuals as well as two-earner married couples should be eligible for the deduction. None of the tax reform proposals follow this approach.

TREATMENT OF HEADS OF HOUSEHOLDS

At low and moderate levels of income, heads of households with taxable sources of income have faced the greatest relative increase in tax rates in the postwar era. One of the primary causes was the failure of the personal exemption to keep up with inflation.[14] This shift in relative tax burdens is particularly important because the proportion of taxpayers that are single heads of households with dependents has increased more than threefold, from 2.6 percent to 8.8 percent, between 1962 and 1982.[15] In addition, while poverty scales and other measures show that it costs about the same to support a given standard of living for an adult with one child as for two adults, the tax system generally treats two adults more favorably even when both have the capability of working and there are no additional expenses for dependents.

The Treasury Department's proposal would help alleviate this situation in two ways. First, the value of the dependent exemption would be increased from $1,090 to $2,000. Second, the level of the ZBA is raised so that it falls slightly more than halfway between the ZBAs for single returns and joint returns. (Under current law the ZBA for heads of household returns is set at the level of a single return). Although the proposed increase in the ZBA for heads of households under the Treasury Department's proposal may be desirable on equity grounds, it also increases the divorce bonus. For most taxpayers, however, the divorce bonus is probably too low to offset the high monetary and personal costs of divorce. The Bradley-Gephardt proposal recognizes the special circumstances of heads of households by providing a higher personal exemption for the taxpayer ($1,800 rather than $1,600). The Kemp-Kasten proposal also provides relief by increasing the amount of the dependent exemption from $1,090 to $2,000.

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[14] See Steuerle, *Op. Cit.*

[15] Internal Revenue Service, various issues.

TREATMENT OF CHILD AND DEPENDENT CARE EXPENSES

Current law provides a nonrefundable credit for certain child and dependent care expenses. Congress justified this credit on the grounds that these expenses must be incurred by many taxpayers to earn a living and are comparable to other business expenses. If this rationale is accepted, however, the expenditures should be deductible, like other business expenses, rather than creditable.

Another rationale for the child care credit or deduction is to adjust for the failure of the tax system to tax imputed income derived from the provsion of child care services by the spouse who does not work outside the home. The deduction would ensure that persons who purchase child care services would be treated the same as those who provide the services themselves: both activities would be tax-exempt. If this approach is accepted, however, persons who neither purchase child care services nor provide it themselves would be treated less favorably, because they do not have imputed income from child care services.[16]

Others would argue that a child-care credit or deduction is justified in order to treat more equally those who work outside the home and those who work in the home—even if the taxation of imputed income for working in the home is not the issue. For example, a single head of household earning $15,000 outside the home and paying $4,000 for child care has less ability to pay tax than a two-earner couple with $15,000 of income earned outside the home, but no child care costs.

Under current law the credit for dependent care expenses is targeted to benefit low-income taxpayers. Implicitly, the current credit favors work outside the home for certain lower-income taxpayers and discourages work outside the home for higher-income taxpayers. With a given rate schedule, it may be desirable to target the cost of a child-care allowance in this manner in order to increase the progressivity of the tax system. When rate schedules can be changed at the same time, however, any degree of progressivity can be established at any income level. Under the Treasury Department's proposal, the complicated dependent care credit is replaced with a simpler deduction for both itemizers and non-itemizers. This change reflects the view that expenditures for child and dependent care are an expense related to earning income. Further, these expenses, which are incurred in order to obtain or maintain employment, affect the taxpayer's ability to pay taxes at all income levels. The Bradley-Gephardt proposal would also allow a deduction for all taxpayers for child care expenses. However, the deduction would be allowed only against income taxed at the 14 percent rate, providing, in effect, a 14 percent credit for eligible expenses. The Kemp-Kasten proposal would disallow deductions for these expenses.

TRANSFERS WITHIN THE FAMILY

Because of progressive tax rates, parents with significant wealth can reduce their tax liability by shifting taxable income to their children. Parents generally shift taxable income to their children by giving income-earning assets to their children or by establishing trusts that pay income to their children. Because of this asset shifting, a portion of the family's income will be taxed at the child's lower marginal tax rate. In effect, current law allows a family to split its income among family members and thereby reduce its aggregate tax liability.

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[16] McIntyre and Oldman (1977), p. 225.

The ability to reduce taxes by shifting investment income to children primarily benefits wealthy taxpayers. Families whose income is largely from wages, i.e., those with only modest amounts of savings, do little income shifting and therefore pay tax on almost all income at the parents' marginal tax rate. These parents are unable to allocate a portion of their wages or income on their savings to their children who have lower marginal tax rates.

Under the Treasury Department's proposals, property income of children who are under 14 years old would be taxed at the parents' marginal tax rate. The child would still be allowed a personal exemption of $2,000 in addition to the $2,000 dependent exemption taken by parents or guardians. In addition, the use of various trust instruments to shift income among family members would be restricted. Some exceptions would be made where it was clear that the property derived from the child's own earnings or from transfers from persons other than the parents. The Bradley-Gephardt and Kemp-Kasten proposals would also reduce the attractiveness of trusts by taxing trust income at the top marginal tax rate and by changing various "throwback" rules which determine how trust income will eventually be calculated.

TREATMENT OF THE POOR: THE EARNED INCOME TAX CREDIT

Under current law, the ZBA and personal exemptions are the primary instruments for exempting the poor from taxation. Current law also provides relief for the poor through the earned income tax credit (EITC). The EITC is a refundable credit against income taxes for a portion of the earned income of certain low income households with children. The EITC reduces income taxes on the earnings of the poor and provides refunds to those with no income tax liabilities.

One objective of the EITC is to increase the incentives to work for those on welfare. When it was enacted, it was viewed as a way of reducing inequities in public assistance coverage between working and non-working poor and of encouraging the poor to seek work. As a pure welfare program, the EITC might be viewed as deficient because it is inversely related to need for incomes up to $5,000, that is, those with earned incomes of $5,000 receive a larger credit than those with earned incomes of $3,000. Nevertheless, the larger credit may be justified, if the purpose of the credit is to increase work incentives. In addition, the credit is not related to family size, although larger families are in greater need of assistance than smaller families. Other welfare programs and tax provisions take differences in family size into account.

In order to restrict the benefits of the EITC to low income persons, it must phase out in certain income ranges. In those phase-out ranges, the incentive to earn an additional dollar is actually reduced because the gradual loss of credit that accompanies increased income is similar to a tax on that increased income. Under current law, the EITC begins to phase out when earned income reaches $6,500. For families with earned incomes of $6,500 or more, the EITC reduces the incentive to work more, although the incentive to work rather than not work increases because the credit adds to after-tax income. For families with incomes of $5,000 or less the EITC provides incentives both to work in general and also to earn an extra dollar for additional work.

Another objective of the EITC is to moderate the effect of the payroll tax (social security tax) on low income workers. Because the payroll tax is levied on the first dollar of earnings up to the maximum taxable amount, it is a heavy burden on low income workers. However, the EITC is an inadequate offset for payroll taxes, because the credit rate is lower than the social security tax rate.[17] Moveover, if the credit is viewed solely as a payroll tax offset, it should be extended to all working poor, including single persons and married couples without children. Extending the credit to these groups would be costly. In addition, it would be difficult to prevent certain individuals who are not poor in actuality—such as working children—from claiming the credit.

Despite the incomplete application of the EITC to its various objectives, the Treasury Department's proposal retains it and indexes the dollar amounts for inflation. If the credit were repealed, one of the goals of the Treasury Department's proposals—maintaining the current distribution of the tax burden—could not be achieved. Because the EITC is the only refundable credit applying to individuals, its repeal would raise the negative tax burden of many low income individuals to zero or higher. If a major redesign of the credit is believed to be desirable, it probably should be considered in the context of an examination of all forms of direct and indirect assistance for low-income families.

The Bradley-Gephardt proposal would retain the current EITC. The Kemp-Kasten proposal would increase the credit percentage, but would phase out the credit faster than current law. The Kemp-Kasten proposal would also index for inflation the dollar amounts of the credit.

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[17] The earned income credit rate is 11 percent. For 1986 the combined employer and employee payroll tax rate will be 14.3 percent.

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FAMILY CHARACTERISTICS AND HORIZONTAL EQUITY: A COMPARISON OF THREE TAX REFORM PROPOSALS*

Gregg A. Esenwein**

ABSTRACT

Reforming the Federal individual income tax is an issue which has generated considerable interest in recent months. Three of the most prominent tax reform plans are the Bradley/Gephardt, Kemp/Kasten, and Treasury proposals. A reoccurring theme in the debate over tax reform is that of horizontal equity, the equal tax treatment of equals. Of the various factors which tend to influence horizontal equity, two, marital status and family size are the subject of analysis in this report. The purpose of the report is to analyze how these three reform proposals differ in their treatment of marital status and family size and how these differences affect horizontal equity.

INTRODUCTION AND SUMMARY.

Reforming the Federal individual income tax is an issue which has generated considerable interest in recent months. Numerous proposals have been offered and several have been introduced as legislation in the 99th Congress. Of these, the two legislative proposals receiving the greatest attention are the Bradley/Gephardt "Fair Tax Act of 1985" (H.R. 800/S. 409) and the Kemp/Kasten "Fair and Simple Tax Act of 1985" (H.R. 777/S. 325). The Treasury Department has also been involved in studying tax reform, recently releasing an option paper entitled "Tax Reform for Fairness, Simplicity, and Economic Growth".

There are three commonly accepted goals of equity under an income tax; progressivity, marriage neutrality, and the equal taxation of those with equal incomes. Progressivity involves questions of vertical equity, while marriage neutrality and the equal taxation of equals involve horizontal equity issues. A problem arises, however, in that the three goals tend to be mutually exclusive. That is, in general, an income tax can be designed to achieve any two of the goals, but it can not simultaneously achieve all three. Hence, reforming the income tax system by definition will involve choices among these three competing concepts of equity.

In the current debate over tax reform, progressivity has not been an issue and the debate has focused on issues of horizontal equity. The current income tax system is often criticized as violating horizontal equity in that similarly situated individuals often pay very dissimilar amounts of income tax. These horizontal inequities occur, in part, because under the current income tax system an individual's tax liability is influenced by the source of his income, the use of his income, his marital status, and the size of the taxpaying unit to which he belongs.

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* EDITOR'S NOTE.—Since this paper was orginally prepared, the Kemp-Kasten tax proposal has been amended slightly. The changes most relevant to the analyses in this report are the increase in the Zero Bracket Amount (ZBA) for heads of households and the decrease in the ZBA for single taxpayers and married couples filing jointly.

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Of the various factors which tend to introduce horizontal inequities into the tax system, two, marital status and family size, are the subjects of analysis in this report. All three of the tax proposals mentioned earlier would affect either implicitly or explicitly, the influence of marital status and family size as determinants of tax liability. The purpose of this report, therefore, is to analyze how these tax proposals differ in their treatment of marital status and family size and what these differences mean in terms of horizontal equity.

The remainder of this section contains a brief summary of findings of the analysis. The second section provides a detailed description of how, under each reform proposal, marital status would influence final tax liabilities. The final section examines how tax liabilities would vary among families of different size and filing status under the three reform proposals.

All three of the tax reform proposals would continue to define married couples as the tax unit and would, as a consequence, continue to violate the principle of marriage neutrality. In addition, all three proposals would repeal the two-earner marital deduction. Other structural changes would also affect the magnitude and extent of the maximum marriage penalty under each reform proposal. Based on the analysis contained in section I, the following observations regarding the maximum marriage penalty experienced by two-earner couples with 50/50 income splits are possible:

1. Bradley/Gephardt would eliminate the "marriage penalty" for two-earner married couples with incomes below approximately $50,000. Two-earner married couples with incomes above $50,000 would experience a "marriage penalty", but in most cases, it would be less than the penalty under current income tax law.
2. Kemp/Kasten would substantially increase the maximum "marriage penalty" compared to current tax law for two-earner married couples with incomes of $30,000 or less. Two-earner married couples with incomes in excess of approximately $40,000 would experience a substantial reduction in the maximum "marriage penalty".
3. The Treasury proposal would also increase the maximum "marriage penalty" for two-earner married couples with incomes of approximately $50,000 or less. The increase, however, would be smaller than that under the Kemp/Kasten proposal. Two-earner married couples with incomes over $50,000 would experience a slight reduction in the maximum "marriage penalty" as compared to current law.

Under the current income tax system, there is a wide variance in the effective income tax rates of families with equal pre-tax standards of living. In general, large families tend to bear a relatively larger tax burden than do smaller families. By calculating the effective income tax rates of families with different characteristics but equal pre-tax standards of living, it was possible to determine how these three tax reform proposals would affect this aspect of horizontal equity. Based on these calculations, the following observations can be made.

1. Bradley/Gephardt would increase the differentials in effective income tax rates for families of varying size who have pre-tax incomes which would equate their standards of living. That is, large families would be taxed more heavily relative to small families than they are under the current income tax system. The child care provisions contained in the Bradley/Gephardt proposal help to mitigate these differentials for those families with child care expenses, but in the aggregate do not reduce them below current law levels.
2. The Kemp/Kasten proposal would substantially reduce the differentials between the effective income tax rates of large and small families with equal pre-tax standards of living. Although Kemp/Kasten would eliminate the child care provisions, other structural changes are such that there would be a more equal distribution of the tax burden than under current law, among families of varying size and filing status.
3. The Treasury proposal would also substantially reduce the differentials between the effective income tax rates of large and small families with equal pre-tax standards of living. The Treasury's child care provisions reduce the differentials even further and would come close to equating the effective income tax rates of large and small families with equal pre tax standards of living.

The three tax reform proposals in question were forced to make a choice between three competing concepts of equity. All three proposals opted for progressivity. Bradley/Gephardt appears to stress elimination of the marriage penalty at the expense of greater inequality between the relative tax burdens of families of different size and filing status. Both Kemp/Kasten and the Treasury take the opposite tack, emphasizing more equality in the relative tax burdens of large and small families, while at the same time producing a much more pronounced marriage penalty.

I. THE MARRIAGE PENALTY AND TAX REFORM

One widely accepted goal of the individual income tax is that it should be marriage neutral. Marriage neutrality means that the tax system should not influence the choice of individuals with regard to their marital status. Marriage neutrality, however, tends to conflict with two other concepts of equity: that couples with the same income should pay the same tax and that the tax system should be progressive.[1]

By defining the married couple as a single tax unit, the current individual income tax violates the principal of marriage neutrality.

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[1] It should be noted that the argument for equal taxation of couples with the same total income is weakest when the comparison is between two-earner married couples and one-earner married couples. It can be argued that in this case the couples are, in fact, not equal since the one-earner couple benefits from the extra time available to the nonworking spouse, a benefit not available to the two-earner couple. If this principle is accepted, then the three concepts of equity are no longer in conflict.

Some married couples pay more income tax than they would as two singles, while other married couples pay less income tax than they would as two singles. The current tax system creates a situation in which there are both marriage penalties and marriage bonuses.[2]

The existence of the marriage penalty has long been recognized and the Economic Recovery Tax Act of 1981 contained provisions designed to mitigate the problem. As a result of the 1981 Act, two-earner married couples are allowed to exempt from tax 10 percent of the lower earning spouse's earned income (the maximum deduction is $3,000). Although this partial deduction helps alleviate the marriage penalty, it does not eliminate it in all cases.

The three most important structural factors affecting the marriage neutrality of an income tax are the personal exemptions, standard deductions (zero bracket amounts), and the tax rate schedules. For the system to be marriage neutral, the personal exemption, standard deduction, and tax rate brackets for a joint return should be twice that of a single return. This, in essence, would produce a system comparable to optional separate filing.

The largest penalty is experienced by couples whose income is equally divided. The penalty occurs because the income of one spouse is added on to the income of the other spouse and taxed a higher marginal rate that it wuld have been if they both filed single returns. Had the joint tax rate brackets been exactly twice that of the single schedule, the penalty would not occur.

Under 1985 income tax law, the personal exemption for a single return is $1,040 and the personal exemption for a joint return with no dependents is $2,080. The standard deduction for a single return is $2,390, while the standard deduction for a joint return is only $3,540, less than twice the standard deduction for a single return. This trend continues throughout the tax rate structure, where for joint returns, the income level at which a given tax rate is applied is always less than twice that of a single return.

This section focuses on how these tax reform proposals would affect couples experiencing the maximum marriage penalty, those with 50/50 income splits. Table 1 shows the marriage penalty for these couples under 1985 law, Bradley/Gephardt, Kemp/Kasten, and the Treasury tax reform proposal. The penalty is measured in terms of the percentage difference in the tax liability of a married couple compared to two singles with the same income. For example, as seen in column 1, the tax liability of a two-earner married couple with $20,000 of income would be about 5 percent more than two singles. The penalty under current law increases as incomes increase, peaking at around $75,000. At incomes above $75,000, the penalty declines because the rate of progression in the tax rates for joint returns starts to flatten out.

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[2] Marriage bonuses occur only when one spouse earns more than 80 percent of the couple's total income. The maximum marriage penalty occurs when each spouse earns 50 percent of the total income. Given recent changes in public attitudes, it has been suggested that the existence of marriage bonuses present less of a problem than marriage penalties, since fewer people would be expected to marry solely to reduce their tax liabilities compared to the number of singles who might opt for cohabitation rather than marriage in order to reduce their tax liabilities.

TABLE 1.—PERCENTAGE DIFFERENCE IN TAX LIABILITY OF TWO-EARNER MARRIED COUPLES AND TWO SINGLES [1]

[In percent]

Combined income level	Current law (1985)	Bradley/ Gephardt	Kemp/Kasten	Treasury
$20,000	4.79	0	28.79	17.31
$25,000	6.08	0	17.92	11.69
$30,000	8.73	0	13.01	8.82
$40,000	10.92	0	8.41	15.13
$50,000	13.51	21.00	6.21	13.97
$75,000	15.65	13.10	3.75	12.80
$100,000	12.44	8.12	2.41	10.29

[1] Assumes all income is wages/salaries, that the standard deduction was taken and that the married couples had a 50/50 income split.

Under the Bradley/Gephardt plan, the marriage penalty would be eliminated for two-earner married couples with incomes below $40,000. At these income levels, the combined standard deduction and personal exemptions for a joint return are $9,200, exactly twice that of a single return. In conjunction with a flat tax rate of 14 percent for both joint and single returns, those structural changes result in marriage neutrality.

At income levels above $40,000, however, the Bradley/Gephardt proposal would produce a marriage penalty. The penalty would be most pronounced for two-earner married couples at the $50,000 income level. The reason for the marriage penalty at these income levels is the surtax on adjusted gross income (AGI). The surtax for joint returns kicks in at 12 percent for AGI in excess of $25,000 for singles and $40,000 for joint filers and 16 percent for AGI in excess of $37,500 for singles and $65,000 for joint filers. Since the AGI levels at which the surtax becomes effective for joint returns are less than twice the levels where they become effective for single returns, two-earner married couples subject to the surtax will pay more tax that would two singles.

Under Kemp/Kasten, the marriage penalty for couples with incomes under $30,000 is more pronounced than it is under current law. The reason for this is that the standard deduction for a joint return is $3500, while the combined standard deduction for two singles is $5400.

Since Kemp/Kasten has a flat rate tax and the $1900 difference in the standard deductions is fixed, the marriage penalty as a percentage of tax liability declines as incomes increase. For two-earner married couples with incomes in excess of $40,000, the penalty is less than that under current law.

Under the Treasury proposal, the marriage penalty as a percentage of tax liability is more pronounced than under current law for two-earner married couples with incomes below approximately $50,000. The penalty results from the fact that the standard deduction and associated tax rate schedule for joint returns is less than twice that of single returns. As incomes increase, however, the relative penalty becomes less pronounced, eventually falling below the levels of current law.

To summarize, it appears that Bradley/Gephardt has placed more emphasis on eliminating the marriage penalty than has Kemp/Kasten or the Treasury. Bradley/Gephardt eliminates the penalty for two-earner couples with incomes below $50,000 and reduces the penalty for two-earner couples with incomes above $50,000. Kemp/Kasten increases the penalty for two-earner couples with income below $30,000 and reduces it at higher income levels. The Treasury proposal would also increase the penalty for certain couples, those with incomes below $50,000, while reducing it at higher income levels.

II. Family Size and Tax Reform

One concept of equity that is somewhat difficult to define and, hence, one that has generated considerable debate, is how an income tax should treat families of different size. At one end of the spectrum are those who would argue that children constitute "consumption" (a voluntary expenditure) on the part of their parents. If children do constitute consumption, then there should be no special provisions for families with children, since under an income tax, the assessment of tax should not be influenced by the use of income. At the other end of the spectrum are those that would argue that children represent an investment in the future, an investment in human capital which provides benefits both to the parents and to society in general. If they are an investment, then the costs associated with raising children should theoretically be deductible under an income tax.

There is no clear cut theoretically correct answer to this issue, although it appears that popular opinion falls somewhere between these two extreme views. That is, under an income tax, some attempt should be made to account for differences in family size when income taxes are assessed. The basis for this line of reasoning is that equity requires that each family experience equal sacrifice, families with equal pre-tax standards of living should be assessed taxes such that they are able to maintain equal after-tax standards of living. In other words, families with equal pre-tax standards of living should pay the same percentage of their income in taxes.

For example, assume that a family of four requires $20,000 to maintain a given standard of living, while a family of six requires $30,000 to maintain the same standard. To satisfy the principal of equal sacrifice, each family should pay the same proportion of their income in taxes. That is, they should have the same effective income tax rate. Hence, to be equitable, if the family of four pays $2000 in tax (10 pecent of its income), then the six-person family should pay $3000 in tax (10 percent of its income).

If this is, in fact, the equitable way to assess income taxes the question then becomes: what is the relationship between family size and income levels needed to equate pre-tax standards of living? Several income equivalency indexes have been developed to show the income levels needed to equate the standards of living of different sized families. A common feature of these indexes is that, due to the "club" nature of household goods and economies of scale, the additional increments of income required to maintain a given standard of living decrease as family size increases. For example, if one assumes that a two-person family required $20,000 of income to achieve a given standard of living, a four-person family, rather than needing $40,000 of income, could achieve the same standard of living on, say, $30,000 of income.

To analyze how well these three tax proposals meet this criterion of equity, the tax liabilities of different-sized families with equal pre-tax standards of living were calculated under each proposal. An equivalency index for poverty level budgets was used to determine the income levels needed to equate the pre-tax standards of living of families with two to six members.[3] The income level of a two-person family to which the index was applied was chosen to roughly reflect a median standard of living. It should be noted that this equivalency index was designed to reflect the experiences of families at or near the poverty level and may or may not reflect the relationship of families at median income levels. This analysis assumes, however, that the index is valid for use in equating pre-tax standards of living for median income families.

Three types of family units were used in the analysis, married one-earner, married two-earner, and single head of household. In order to account for the intrinsic value of an adult who stayed at home, it was assumed that to maintain the same standard of living, one-earner married couples required incomes that were $7000 less than the incomes of two-earner married couples and single heads of households. The $7000 amount was chosen to roughly reflect the income that could be earned by an individual with a full-time job that paid the minimum wage. As a result, family incomes ranged from $20,286, for a one-earner married couple with no dependents, to $54,572 for a single head of household with five dependents. It is important that the reader realize that these income levels are assumed to represent the incomes which would equate the pre-tax standard of living of all the families regardless of their filing status or size.

Tables 2 and 3 present the results of these calculations. Table 2 shows the effective income tax rates of families with equal pre-tax standards of living assuming no child care expenses. Table 3 shows the same information assuming child care expenses are incurred. Child care expenses were assumed to be $2400 for one child and $4800 for two or more children.[4]

Certain points about the data contained in these tables are worth mentioning. Due to the nature of the assumptions, the reader is cautioned about placing too much emphasis on the actual numerical values of the data presented. For instance, in tables 2 and 3, across-the-board comparisons of the level of effective tax rates can be misleading since it is not clear that all three proposals would have the same effect on aggregate Federal revenues. The important comparison in these tables is how effective tax rates vary by family characteristics under a given reform proposal.

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[3] Pechman, Joseph A. Federal Tax Policy, 4th ed. The Brookings Institution. Washington, 1983. p. 79.

[4] Under current law, a tax credit is available for certain child expenses incurred for the purpose of being gainfully employed. The maximum expenses to which the credit can be applied is $2,400 for one child and $4,800 for two or more children. Bradley/Gephardt would change this credit to a deduction limited to the employment-related expenses incurred during the taxable year. Kemp/Kasten would repeal the child care credit. The Treasury proposal would change the credit to a deduction subject to the same dollar limitations as current law.

It should also be noted that the family characteristics used in these calculations are not necessarily representative of the population as a whole. They were chosen to provide illustrative examples only. Finally, it should be noted that all three tax reform proposals would reduce the level of income taxes for all of these families compared to the level of income taxes under current law. Hence, in the following analysis, when a tax reform plan is described as reducing or increasing the differences in effective income tax rates among families, the reference is to relative differences rather than absolute differences.

TABLE 2.—EFFECTIVE INCOME TAX RATES OF FAMILIES WITH EQUAL PRE-TAX STANDARDS OF LIVING [1]

Family type and family size	Income levels	Effective income tax rates (percent)			
		Current law 1985	Bradley/ Gephardt	Kemp/ Kasten	Treasury
Married one-earner:					
2	$20,286	10.31	7.65	10.33	9.23
3	25,743	11.46	8.45	10.34	9.29
4	34,202	13.79	9.42	11.13	9.83
5	41,569	15.53	10.34	11.86	10.02
6	48,572	16.98	12.03	12.99	10.81
Married two-earner: [2]					
2	27,286	11.80	9.28	12.60	10.71
3	32,743	12.83	9.64	12.24	10.51
4	41,202	14.72	10.54	12.50	11.04
5	48,569	16.37	12.60	12.53	12.13
6	54,572	17.39	13.82	12.38	12.63
Single head of household:					
2	27,286	15.29	12.03	13.31	10.88
3	32,743	16.52	13.93	12.82	11.18
4	41,202	18.97	16.43	13.34	12.80
5	48,569	20.65	18.20	14.70	13.62
6	54,572	21.79	19.24	15.37	13.96

[1] Assumes all wage/salary income and no itemized deduction.
[2] Assumes 50/50 income split.

TABLE 3.—EFFECTIVE INCOME TAX RATES OF FAMILIES WITH CHILD CARE EXPENSES AND EQUAL PER-TAX STANDARDS OF LIVING INCOMES [1]

Family type and family size	Income levels	Effective income tax rates (percent)			
		Current law 1985	Bradley/ Gephardt	Kemp/ Kasten	Treasury
Married one-earner:					
2	$20,286	10.31	7.65	10.33	9.23
3	25,743	11.46	8.45	11.34	9.29
4	34,202	13.79	9.42	11.13	9.83
5	41,569	15.53	10.34	11.86	10.02
6	47,572	16.98	12.03	12.99	10.81
Married two-earner: [2]					
2	27,286	11.80	9.28	12.60	10.71
3	32,743	11.36	8.61	12.24	9.41
4	41,202	12.39	8.91	12.50	8.96
5	48,569	14.39	11.22	12.53	9.66
6	54,572	15.63	12.59	12.38	10.44
Single head of household: [3]					
2	27,286	13.44	10.80	13.31	9.56
3	32,743	13.59	11.88	12.82	8.45

TABLE 3.—EFFECTIVE INCOME TAX RATES OF FAMILIES WITH CHILD CARE EXPENSES AND EQUAL PER-TAX STANDARDS OF LIVING INCOMES [1]—Continued

Family type and family size	Income levels	Effective income tax rates (percent)			
		Current law 1985	Bradley/Gephardt	Kemp/Kasten	Treasury
4	41,202	16.64	14.80	13.34	9.89
5	48,569	18.67	16.82	14.70	11.15
6	54,572	20.03	18.01	15.37	11.76

[1] Assumes all wage/salary income and no itemized deductions.

[2] Assumes 50/50 income split.

[3] Assumes deductible child care expenses of $2400 for one child and $4800 for two or more children.

As can be seen in tables 2 and 3, under the current income tax system there is a significant variation in the rates of tax paid by essentially equivalent families. This variation in effective tax rates is a result of differences in family size and filing status and indicates an inequitable distribution of the tax burden. With regard to family size, smaller families bear a much lighter tax burden than do larger families. For example, the effective income tax rate of a married one-earner couple with no children is only 10.31 percent while a married one-earner couple with four children and an equivalent pre-tax standard of living has an effective tax rate of 16.98 percent.

Filing status also influences the distribution of the tax burden, with married one-earner couples bearing the lighest burden followed by two-earner married couples. Heads of households incur the heaviest tax burden. For instance, in table 2, a married one-earner couple with two children has an effective tax rate of 13.79 percent, a married two-earner couple with two children has an effective tax rate of 14.72 percent, while a single head of household with three children has an effective tax rate of almost 19 percent.

The child care provisions help to mitigate these differentials, although they are not eliminated. For example, in table 3, the effective tax rate of a single head of household with three dependents is 16.64 percent compared to 18.97 percent in table 2. Hence, in general, the current law child care provisions help to reduce the distortions in effective tax rates between married one-earner families with children and married two-earner/single head of household families with children.

Under Bradley/Gephardt, these same patterns are repeated: large families are taxed more heavily than small families and single heads of households are taxed more heavily than married couples. However, it appears that the distortions in the effective income tax rates among families of different size and filing status are more pronounced under Bradley/Gephardt than under current law. The increase is primarily the result of two structural changes contained in the Bradley/Gephardt plan.

First, the personal exemption for adults filing joint or single returns would be $1600 per person ($1800 for heads of households) while the personal exemption for dependents would only be $1000. This tends to increase the distortions in effective tax rates between families with several children and those with few or no children.

Second, Bradley/Gephardt would, with the exception of the personal exemption, eliminate the head of household filing status. The personal exemption for single heads of households would be $200 more than that of a single, but they would be subject to the same standard deduction and surtax rates as single filers. This change would increase the distortion between the tax burden of families filing joint returns and those of equal size filing head of household returns. The child care provisions under Bradley/Gephardt would help to mitigate these distortions in the tax burdens of similar families, but the distortions would remain larger than those under current law.

As was the case under both current law and Bradley/Gephardt, the same patterns in the distribution of the tax burden appear under Kemp/Kasten. Kemp/Kasten, however, would, when compared to current law, reduce the distortion in effective tax rates among families with equal pre-tax standards of living. It does this primarily through an increase in the personal exemptions and by increasing the standard deduction for head of household returns relative to joint returns. Although Kemp/Kasten would eliminate the current law child care credits, it would still produce a substantial improvement, compared to current law (which includes the child care credit), in the distribution of the tax burden among similarly situated families.

The Treasury proposal would also substantially reduce the distortions in the effective tax rates of families with equal pre-tax standards of living. As was the case with Kemp/Kasten, this improvement is achieved through an increase in the exemptions for dependents and an increase in the standard deduction for heads of households relative to that of joint returns. In addition, the child care provisions contained in the Treasury proposal would effectively eliminate the distortions in the distribution of the tax burden among similarly situated families.

IMPLICATIONS OF TAX ALTERNATIVES FOR FAMILIES: HOW TEN FAMILIES FARE UNDER FIVE TAX PROPOSALS

Martha H. Phillips*

The current tax reform debate and particularly the flat tax concept are motivated by several concerns. Sponsors contend that everyone ought to pay a fair share of the tax burden and that special tax breaks, allowances and exempted forms of income which permit some, usually wealthy, taxpayers to escape most of their tax burden ought to be repealed. There is also a belief that the present tax structure is far too complicated and difficult for our self-administered tax system. Another major emphasis is on reducing the marginal tax rates. The top tax rate is currently 50 percent, twenty percentage points less than the 70 percent rate in effect until 1981.

There are several things the flat tax sponsors do not want to do. They all maintain that enactment of a flat tax ought not to be a revenue-increasing event. Therefore, each proposal is defended by its sponsor(s) as a revenue-neutral plan, (the difficulties of estimating and the debate over static versus dynamic assumptions notwithstanding.) The sponsors do not want to tax those below the poverty level, so each has tried to design a tax structure that puts people with poverty-level incomes below the federal income tax threshold.

The impact on families has always been a factor in tax policy, and more recently, some interest in the impact of tax policy on women has been evident as well. Although these concerns have seldom if ever been a dominant motivation behind major tax initiatives, such considerations have spurred successful efforts to incorporate limited specific features into the present tax system. The same may be true of the current tax reform debate. While there is recognition that women and particularly families may require special attention in the development of a tax alternative, this can hardly be said to be one of the central motivating factors or evaluation criteria.

YARDSTICKS FOR MEASURING IMPACT ON FAMILIES AND WOMEN

The tax code distinguishes quite explicitly in many ways between married couples and single individuals and between single individuals with dependents and those without. However, it is gender-neutral in its draftmanship. (In one instance pertaining to alimony payments, for example, it uses the terms, "husband" and "wife," but these terms are defined so that "husband" can mean "wife" and 'wife" can mean "husband" if the circumstances require.) Nevertheless, it may be useful in this review of flat tax alternatives to keep in mind several yardsticks for evaluating how families and women fare under various schemes.

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The most straightforward analysis, of course, is simply to compute whether an individual or a family will have more or less after-tax income under a proposal compared to present law. This calculation may become more complicated however, if the proposal raises revenues which are then dedicated to a program serving a targeted class of families such as low income families with children or families needing medical assistance. Some families may see their taxes increase but then recoup those taxes and more under the program financed by the new or increased tax. The social security tax operates in this manner to some extent; the taxes fall heavily on low income taxpayers, but retirees with low average earnings receive benefits equal to a higher proportion of their pre-retirement earnings than do workers with higher earnings.

Another consideration is the relative, rather than the absolute, position of taxpayers—whether they will be better or worse off under a proposal than other taxpayers. If, for example, family A is taxed less than family B under present law and under a proposal family B's tax is reduced to the level of family A's, would family A be considered worse off under the proposal than under present law? Although family A's tax liability has remained the same, it no longer enjoys an advantage over its neighbors, family B. If both families experience a net tax reduction or increase at the same time that the gap between their tax liabilities is narrowed or eliminated, an evaluation can be based on either the size of the relative gap or the amount of tax-reduction or increase. Perhaps because it tends to fog political perception, this technique has frequently been used in the past: adjustments in the structure of the tax system generally have been accompanied (paid for, some would suggest) by rate reductions. For example, in the Economic Recovery Tax Act of 1981 (ERTA), all families enjoyed a substantial cut in their tax rates, but two-earner couples were benefited by the creation of a new deduction to compensate them for the marriage tax "penalty" they suffered compared to single workers. In addition, the work-related dependent care credit was increased for families with incomes below $28,000. Some one-earner families who care for their children at home protested that they were treated inequitably because even though they received the same rate cuts as all taxpayers (and therefore have lower taxes today than they would have had without the legislation), they did not get as generous treatment as their two-worker neighbor couples who benefited from the new two-earner deduction and an expanded dependent care credit in addition to the rate reduction.

Another criterion is the treatment of symbolic features of the tax code. Over the years, many adjustments have been made in recognition of special needs and burdens of families of various types. The differential rate structure for married, single and head-of-household taxpayers, the adoption-expense deduction, the two-earner deduction, the earned-income credit, the credit for the elderly, the spousal Individual Retirement Account (IRA) deduction are only a few examples of ways our system of taxes has responded to political pressures to take into account situations in families' circumstances that affect their ability to pay taxes. Some of these adjustments, such as the differential rate structure, the Earned Income Tax Credit [EITC] or dependent care credit, can reduce a family's taxes considerably. But others may have more symbolic than financial importance. For example, the deduction for the first $1500 of legal expenses for adopting a "special-needs" child with handicaps or other problems is worth between $165 and $750 at most, depending on the family's marginal tax rate, a relatively small amount compared to adoption costs. Yet the feeling that the tax code should somehow recognize the extraordinary efforts and expenses involved in these adoptions led to the creation of this deduction. Others have proposed a credit or deduction for care of an elderly or disabled dependent in one's home as a recognition of the extra burdens this entails. If such special deductions are eliminated in order to reduce the tax rates for all families, will taxpayers with special needs be better or worse off? Even though a family's tax burdens may be identical under both present law and a particular proposal, if it benefits from a provision that symbolically recognizes its circumstances, a family might well perceive the tax system as being more favorable.

Some tax provisions have the effect of encouraging or discouraging taxpayer behavior. Some of these effects have been intended, but some have not. The deduction for two-earner couples, for example, was enacted not only in response to equity considerations vis-a-vis this couple's tax burden relative to the burden of two single individuals with the same earnings, but also because it was becoming apparent that at least some two-earner couples were divorcing or postponing marriage in order to avoid the tax "penalty" they incurred at the wedding. Congress wanted to take taxes out of the matrimonial decision process. However, the deduction was structured so that it applied to the first $30,000 earned by the lesser-earning spouse in all two-earner couples, even those who were enjoying a marriage "bonus" relative to two single individuals. The couples in the bonus range were those whose lesser-earning spouse earned, generally, twenty percent or less of the couple's combined income, due to part-time, part-year, or low-paid employment. These couples still benefited from using the joint return zero bracket and rates despite the earnings of the second spouse. Applying the two-earner deduction to such couples not only compensated them for an inequity they had not experienced, but it may have served to encourage work outside the home by some—usually wives—who otherwise might not have felt that their small net return from employment after taxes and work expenses made sense in terms of family priorities.

Horizontal and vertical equity are the traditional ways of measuring tax impact. Horizontal equity is the idea that taxpayers with comparable incomes should pay comparable taxes. Vertical equity is the notion that tax liability should be based on relative ability to pay so that taxpayers with higher incomes should be taxed proportionately more than those with lower incomes. These are not difficult concepts to understand, but they have remained stubbornly difficult to measure or implement. Horizontal equity is confounded by having to allow for differences in family composition, as well as expenditure and earning patterns. Trying to arrive at an equitable tax burden for, say, a husband earning $15,000 with a wife who stays home to care for a child, and a divorced mother who earns $10,000 and receives $5000 in child support payments which just covers the cost of dependent care for her two children while she is at work or a family where the father earns $15,000 to support his wife and teenage son who himself earned $5000 during the summer on a construction job which he will save for college, is at least as much a political exercise as an exact science.

Vertical equity can be measured by ascertaining the portion of the tax burden paid by families at different income levels and by looking at the progressivity of the tax system. Tax cuts or increases that are equal to a specific percentage of tax burden or rate schedule—such as the 23% cut in tax rates enacted in ERTA or the 10% surtax imposed in 1986—will have a greater impact on wealthier taxpayers. A pure version of the flat tax—with everyone paying a fixed percentage of income regardless of family size, marital status or poverty thresholds—would violate the principles of vertical equity. However, most flat tax proposals provide more or less progressivity by exempting from taxation some portion of taxpayers' income. This can be accomplished through a standard deduction, a deduction based on a percentage of earnings, a zero bracket amount, a credit for taxpayers with low income, or through personal exemptions. Several proposals use these in combination to achieve a considerable degree of progressivity while using only one to three tax rates.

Closely related to the issue of progressivity is the tax treatment of families and individuals with incomes below the proverty level. Legislative history in recent years has reflected a fairly explicit intent to make sure that the tax threshold—the income at which people begin to have tax liability—does not fall below the official poverty line. The earned income tax credit, the personal exemption, and the zero bracket amount have been the primary tools to achieve this policy, although the credit for the elderly also helps to provide relief for low income elderly people. The stated goal of not taxing people at or below poverty levels has not been achieved consistently. This is because until recently the personal exemption and the zero bracket amounts were not indexed, and because the earned income tax credit is still not indexed for inflation. Therefore the official measure of poverty rose to ever higher dollar levels while the key tax provisions protecting low-income families were adjusted only occasionally.

Indexation raises the issue of the impact of a proposal on families over time. While families may fare better under a specific proposal initially than they do today, this may not continue to be the case if various thresholds, brackets, exemptions and credits are not indexed to reflect inflation. The earned income tax credit which is available to certain low income families with children and the dependent care tax credit are two examples in present law which have diminishing value—and therefore provide diminishing protection—for families over time, because they are stated in terms of specific dollar thresholds which do not increase along with poverty levels or taxpayers' incomes.

Finally, measuring the impact of tax alternatives on women and families should include an examination of the tax base. Flat tax proposals generally involve widening the tax base to include the value of some forms of income which are not taxable currently. Employee benefits, including medical and disability insurance, group term life insurance, and dependent care assistance provided by the employer may become subject to income tax under various tax options, along with the so-called "cafeteria" feature of some benefit programs which permits employees to select the combination of benefits or taxable compensation most appropriate to their families' needs. When the norm was the breadwinner father and the at-home mother, little need was seen to provide anything other than the so-called core benefits—health insurance, disability coverage and a retirement plan. However, the workplace now includes single mothers, two-earner couples as well as women who have not married. For them, the option to choose among tax-free benefits or taxable cash compensation may be attractive. For low-income single working mothers, access to health insurance at the workplace is a major concern.

Because some types of income are particularly important to women and families at different points in their life cycles, the inclusion or exclusion of these from the tax base is important. In addition to those types of income already discussed, the reliance by the elderly on interest and dividends to supplement their retirement incomes and on whole life insurance should be kept in mind. Other income currently excluded from taxation includes benefits of various types—Aid to Families with Dependent Children, food stamps, Supplemental Security Income, and other types of means-tested assistance. Some benefits, such as social security and unemployment compensation, are partially excluded from taxation, depending on how much other income the family or individual receives. Given the importance for some families of benefits provided by employers and the government, the taxation of these benefits must also be considered in the analysis of any tax proposal's impact.

DESCRIPTION OF FLAT TAX ALTERNATIVES

Of the many proposals for flattening the federal income tax system, five will be discussed in this paper and compared with present law. They are S. 409/H.R. 800, the "Fair Tax Act of 1985" sponsored by Senator Bradley and Representative Gephardt; S. 1006/H.R. 2222, the "Fair and Simple Tax Act of 1985", FAST, sponsored by Representative Kemp and Senator Kasten; the Treasury proposal of November, 1984 (including effective date modifications announced by Secretary Baker on February 27, 1985); H.R. 200, the "Ten Percent Flat Tax Rate Act" sponsored by Representative Siljander; and S. 321 sponsored by Senator DeConcini.[1] These alternatives by no means comprise the entire list of flat tax proposals and the choice of these five was intended to include the alternatives being most widely discussed as well as a range illustrative of the variations possible under a flat tax.

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[1] All bill numbers are for the 99th Congress. For further descriptions of the following, see: (Bradley-Gephardt) Bill Bradley, *The Fair Tax* (New York: Simon and Schuster, 1984); (Kemp-Kasten), *Congressional Record*, January 31, 1985, (remarks of Senator Kasten and Congressman Kemp; pp. S 894-902, E 288-291) and *Congressional Record*, April 29, 1985, (remarks of Congressman Kemp; pp. H2879-2880); (Treasury) U.S. Office of the Secretary, Department of the Treasury, November 1984, *Tax Reform for Fairness, Simplicity and Economic Growth*, Vol. 2; (Siljander) Hearings before the House Committee on Ways and Means, 99th Cong., 1st Sess. March 27, 1985, testimony of Congressman Mark D. Siljander; (DeConcini) Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Stanford, Ca.: Hoover Institution Press, 1985).

CHART 1.—COMPARISON OF TAX ALTERNATIVES AND PRESENT LAW

	1986 Present law	S. 409/H.R. 800 (fair) Bradley-Gephardt	S. 1006/H.R. 2222 (fast) Kemp-Kasten	Treasury	H.R. 200 Siljander	S. 321 DeConcini
Exclusions from and adjustments to income:						
1 Fringe benefits exclusions.	Excludes: Cafeteria plans; education asst. expires 12/31/85; legal services exp. 12/31/85; dependent care assistance; qualified transportation; health insur.; grp. term life insurance up to $50,000; Pension plan contributions; death benefits	Repeals exclusion of: cafeteria plans; qual. transp.; dep. care asst.; grp. term life insurance in excess of employee's contrib. (permits educ. asst. and legal services to expire.); health insurance	Repeals exclusion of: Legal services; qual. transport. (permits educ. and legal services to expire.)	Repeals excl. of: Cafeteria plans; educ. asst.; legal services; dep. care asst.; qual. transp.; grp. term life ins.; health insurance includes employer's payments. over $70/mo. for individual and $175/mo. for family coverage. (indexed)	Repeals excl. of: Cafeteria; education; legal asst.; dep. care asst.; qual. trans.; health ins.	Excludes goods and services provided employees, including medical benefits.
2. Interest income	Interest rec'd included in income unless specifically excluded (as for tax exempt bonds, IRAs)	Same as present law	Same as present law	Net interest income, indexed, included (indexing phased in beginning with 20 percent exclusion in 1989 and 10 percent increases annually thereafter until full indexing is reached.)	Same as present law	Included.
3 Dividends	Excludes $100/single, $200 joint of qualifying dividends	Repeals dividend exclusion	Repeals dividend exclusion	Repeals dividend exclusion	Repeals dividend exclusion	Repeals dividend exclusion.
4. Unemployment compensation	UC excluded if other income + UC is below base amts. of $12,000/single or $18,000/joint returns. Over the base amts. the lesser of one-half the excess or the amt. of UC is included	Exclusion repealed, include all UC	Exclusion repealed, include all UC	Exclusion repealed, include all UC	Same as present law	Exclusion repealed, include all UC.

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CHART 1.—COMPARISON OF TAX ALTERNATIVES AND PRESENT LAW—Continued

	1986 Present law	S. 409/H.R. 800 (fair) Bradley-Gephardt	S. 1006/H.R. 2222 (fast) Kemp-Kasten	Treasury	H.R. 200 Siljander	S. 321 DeConcini
5. Social Security benefits	Excluded if other income + S.S. is below base amts. of $25,000/single or $32,000/jt. returns; one-half of benefits included above the base amts. Base includes income from tax-exempt bonds	Same as present law	One-quarter of benefits included above base amount	Same as present law	Excluded	Included.
6. 2-earner deduction	10 percent of first $30,000 of lesser earner's wages	Repealed	Repealed	Repealed	Repealed	Repealed.
7. IRA	Ded. of 100 percent of compensation up to $2,000 + $250 for spouse with no income	Same as present law	Same as present law	Ded. of 10 percent of compensation up to $2,500 per taxpayer	Same as present law	Repealed.
8. Cash or deferred retirement savings (401 k) plans	Exclusion of amount of compensation deferred and contributed to a qualified plan up to lesser of $30,000 (indexed) or 25 percent of compensation, subject to non-discrimination test	Reduce limit to $20,000 and eliminate indexing	Same as present law	Repealed	Repealed	Repealed.

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SUMMARY COMPARISON OF TAX ALTERNATIVES AND PRESENT LAW—Continued

9. Employment income exclusion	No provision	No provision	20 percent of earnings under the FICA base; phase out thereafter at 20 percent of income over FICA base, with 20 percent of excess after phase-out included in income; special rule for earnings of less than $10,000 (indexed) for singles and h/h, $15,000 (indexed) for jt. returns (applied separately to each spouse's earnings)	No provision	No provision	No provision.
Deductions:						
10. Charitable contribution deduction for nonitemizers	100 percent of all gifts (expires after 1986)	Deduction allowed for nonitemizers	Same as present law	Repealed	Same as present law	Repealed.
11. Charitable cont. to public charities—for itemizers	100 percent of all gifts contributions up to 50 percent of AGI	Same as present law, except applies only to 14 percent bracket	Same as present law	Only contrib. in excess of 2 percent of AGI are deductible, no limit on percent of AGI	Same as present law	Repealed.
12. Medical expenses	Deductible for itemizers above 5 percent of AGI.	10 percent floor, applies only to 14 percent bracket	10 percent floor	Same as present law	Repealed	Repealed.
13. Adoption expenses	Itemizers may deduct expenses up to $1,500 for costs of adopting child w/ special needs	Repealed	Same as present law	Repealed	Repealed	Repealed.
14. Deduction of non-business home mortgage interest payments	Deductible	Same as present law (all interest applies to basic tax, only interest net of investment interest applies to surtax.)	Same as present law	Only on principal residence (on debt up to fair mkt. value of residence) (interest not indexed)	Same as present law	Repealed.
15. Deduction of non-business (consumer) interest	Deductible	Deductible only to extent of qualified net investment income (adjustment to total income)	Deductible only on indebtedness to pay educational expenses	First $5,000 (10,000 in 1986 and 1987) of interest payments fully deductible, additional interest indexed. (indexing effective in 1988.)	Same as present law	Repealed.

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CHART 1.—COMPARISON OF TAX ALTERNATIVES AND PRESENT LAW—Continued

	1986 Present law	S. 409/H.R. 800 (fair) Bradley-Gephardt	S. 1006/H.R. 2222 (fast) Kemp-Kasten	Treasury	H.R. 200 Siljander	S. 321 DeConcini
16. Deduction for state & local taxes	Ded. for itemizers of st. and loc. real and pers. prop. tax, sales, excise and income taxes	Repeals deduction for personal property, and sales taxes; deduction for real property and income taxes same as present law. Applies only to 14 percent bracket	Repeals deduction for sales, income, and personal property taxes	Phases out deduction for nonbusiness st. and local income and other taxes (50 percent ded. in 1986, 0 percent thereafter)	Same as present law	Repealed.
Exemptions:						
17. Personal exemption	$1,090 (indexed)	$1,600/taxpayer; $1,600/spouse; $1,800/h/h; $1,000/dependents; (not indexed)	$2,000 (indexed)	$2,000 (indexed)	$2,100 (indexed)	$9,450/married; $8,400/h/h; $4,725/single; $1,890/dependent (indexed).
18. Additional exemption for over 65 or blind	$1,090 (indexed)	$1,000 (indexed)	$2,000 (indexed)	Repealed and folded into a credit (see 23 below)	Repealed	Repealed.
Zero bracket:						
19. Zero brackets/standard deduction:.						
Joint return	$3,710	$6,000	$3,300	$3,800	Repealed	Repealed.
Single	$2,510	$3,000	$2,600	$2,800		
Head of househ.	$2,510	$3,000	$3,200	$3,500		
	(indexed)	(not indexed)	(indexed)	(indexed)		
Rate schedules:						
20. Rate schedules	14–15 brackets ranging from 11 percent to 50 percent; separate schedules according to family status; indexed	3 brackets 14–26–30; different schedules for married and single; not indexed; 14 percent rate applies to taxable income, other 2 brackets apply to AGI	1 rate of 24 percent for all taxpayers	3 brackets 15–25–35; separate schedule according to family status indexed	1 rate of 10 percent of adjusted gross income for all taxpayers	1 rate of 19 percent for all taxpayers.

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CHART 1.—COMPARISON OF TAX ALTERNATIVES AND PRESENT LAW—Continued

Credits:						
21. Earned income credit	11 percent of first $5,000, phased out at $12\frac{2}{9}$ percent between $6,500 and $11,000, maximum credit is $550. (not indexed)	Same as present law	FICA rate (14.3 percent in 1986) times applicable amount: $4,500–1 qualfied dependent $5,000–2 qual. dep. $5,500–3 or more qual. dependents phase out at 15 percent rate. Maximum 1986 EITC: $644, 715, 787. (indexed)	Same as present law, but indexed. 1986 levels: 11 percent of $5,250, max. credit of $578, phaseout at $11,550. 125 percent of 1986 levels: 11 percent of $6,563, max. credit of $722, phaseout at $14,375	Credit repealed	Credit repealed.
22. Dependent care	30–20 percent credit on expenses up to $2,400 for one dependent, $4,800 for two or more	Deduction of expenses up to $2,400 for one dependent, $4,800 for two or more; nonitemizers may use this ded.	Credit repealed	Deduction of expenses up to $2,400 for one dependent, $4,800 for two or more; nonitemizers may use this ded.	Credit repealed	Credit repealed.

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OVERVIEW

Chart 1 details many of the specific provisions affecting individual taxpayers from each of the tax proposals. The focus here is on the "meat and potatoes" provisions used by most families; therefore the provisions relating to sophisticated tax shelters, income from businesses and capital and esoteric items ignored by all but the most dedicated tax avoiders are omitted. Plans have been indexed where appropriate to their 1986 levels, the first effective year for several of them.

Present law, of course, is a graduated system with 14 or 15 tax brackets imposed on progressively higher income levels. It exempts $1,090 for each individual in the tax-filing unit—a low amount in constant dollars historically speaking—and exempts from tax the first $3,710 for joint returns and $2,510 for single individuals and heads of households. The base on which this tax is imposed excludes a number of types of income and tax-advantaged savings. A large number of deductions from income and credits against tax liability are provided. Many of these have been created and modified through the years in an effort to add fairness and equity to the tax system. Critics of the present system charge that these complications have achieved not fairness, but only the perception of increased unfairness, because each taxpayer probably can find someone who gets a greater advantage from these deductions and credits. Defenders of the present complexities point out that simplicity is the enemy of equity and that these twists and turns were added for good reasons.

The flat tax alternatives have a number of features in common. First, all but one would expand the tax base by including in taxable income a number of employee fringe benefits. All plans but one would include all unemployment compensation in taxable income. They all would repeal the deduction in present law for two-earner couples—the flat tax is perceived as largely or entirely eliminating the marriage penalty. They all would continue the tax advantage for Individual Retirement Accounts. All but one would provide current or more generous exclusions for social security income. All the plans would repeal the $100 dividend exclusion. Only one of the plans specifically would extend the charitable contribution deduction which is permitted for non-itemizers. All the proposals repeal the dependent care tax credit; two of them replace it with a deduction available whether or not other deductions are itemized.

BRADLEY-GEPHARDT

The Bradley-Gephardt proposal would use three tax rates and two tax bases. First, a "normal tax" of a flat 14 percent would be imposed on taxable income. Then, for higher income taxpayers, 12 and 16 percent surtaxes would be imposed on adjusted gross income. For joint returns, the 12 percent surtax would be levied on AGI from $40,000 up through $65,000 and the 16 percent surtax would apply to AGI over $65,000. For returns filed by single individuals and single heads of households, the 12 percent surtax would apply to AGI from $25,000 up through $37,500, and the 16 percent surtax would apply to AGI over $37,500. (For purposes of the surtax, nonbusiness interest could be deducted from AGI up to the amount of investment income; no other deductions from AGI would be permitted.) The combination of the normal tax and the surtaxes would yield marginal tax rates of 14, 26 and 30 percent rather than the 11 to 50 percent rates currently in effect under present law.

In computing taxable income, non-itemizers would be permitted to use a standard deduction of $6,000 on joint returns and $3,000 on returns of both single individuals and heads of households. This pattern of permitting heads of household to exempt only as much as single individuals is in keeping with present law which does likewise. Under present law the gap between the zero bracket of joint returns and other returns is only $1,200 compared with the $3,000 difference under Bradley-Gephardt. This difference would not be offset very much by the $1,800 personal exemption for a head of household, compared with $1,600 apiece for taxpayers on a joint return. In a "worst-case" comparison between a married couple with one dependent and a single mother with two teenagers, these two provisions would add up to a difference of $3,400 under Bradley-Gephardt compared with $1,200 under the present law. Despite this gap, the head of household nontaxable amount would increase from $5,780 in 1986 under present law to $6,800 under Bradley-Gephardt. Because Bradley-Gephardt would eliminate indexing, however, this advantage would be wiped out after 17.6 percent inflation had occurred.

The Bradley-Gephardt plan would repeal the dependent care tax credit and permit both itemizers and non-itemizers to deduct dependent care expenses up to the present maximums of $2,400 for one dependent and $4,800 for two or more. The earned income tax credit for low-income families with children would be continued at present rates and dollar amounts.

Several changes would be made in deductions. Most noteworthy is that itemized deductions would be allowed only against the bottom 14 percent basic tax bracket but not against the surtax brackets. This would reduce the value of deductions for taxpayers whose income places them in the surtax range, which would begin at $25,000 for single and head of household taxpayers and $40,000 for joint returns. The charitable contribution deduction, the deduction for state and local income and property taxes and the medical expense deduction (which counts only expenses over 10 percent rather than 5 percent of AGI as under present law) would be worth only 14 cents on the dollar, regardless of the taxpayer's income. The deduction for mortgage interest would be limited to interest payable with respect only to the taxpayer's principal residence. The deduction for non-business (consumer) interest would be allowed only to the extent that it offset interest income the taxpayer receives from investments or savings.

The Bradley-Gephardt proposal, in contrast to the other four alternatives discussed here, would repeal present law indexing. Its sponsors argue that the large increase in the standard deduction would more than compensate for several years of indexing of the zero bracket and personal exemption; that with only three brackets, bracket-creep would be minimized; that Congress generally cuts taxes in response to the impact of inflation; and that eliminating indexing would permit Congress to choose to adjust taxes to generate additional revenues or to give the economy a boost.

KEMP-KASTEN

A notable feature of the Kemp-Kasten proposal is the creation of an exclusion equal to 20 percent of employment income of each taxpayer up to the FICA base. (The FICA base is the maximum dollar amount of each employee's annual wages on which a payroll tax is levied under the Federal Insurance Contribution Act; the proceeds from this tax are used for the social security retirement, survivors, disability and hospital insurance programs.) This exclusion would apply separately to husbands and wives; each would get an exclusion on his/her earnings and thus a marriage penalty would be avoided. The FICA base will be $41,700 in 1986 according to current estimates and is expected to reach $49,800 by 1989. Taxpayers with earnings of less than $10,000 (indexed) for single individuals and heads of household and $15,000 for joint returns would be permitted to add investment income, if any, to their earnings for purposes of computing this exclusion. The exclusion would be reduced for taxpayers with incomes in excess of the FICA base by an amount equal to 20 percent of income in excess of the FICA base. Thus, when a taxpayer had income of double the FICA base ($83,400 in 1986) the exclusion would be phased out completely. At still higher incomes, the proposal provides for including in gross income an amount equal to 20 percent of income in excess of double the FICA base. This would produce the following results:

EMPLOYMENT INCOME EXCLUSION UNDER "FAST" (1986)

Income	Computation	Exclusion (−) or incluson (+)
$20,000	($20,000X0.20=$4,000)	−$4,000
$40,000	($40,000X0.20=$8,000)	−8,000
$41,700	($41,700X0.20=$8,340)	−8,340
$60,000	($60,000−$41,700=$18,300; $18,300X0.20=$3,660; $8,340−$3,660=$4,680)	−4,680
$83,400	($83,400−$41,700=$41,700; $41,700X0.20=$8,340; $8,340−$8,340=0)	0
$100,000	($100,000−$83,400=$16,600; $16,600X0.20=$3,220)	+3,220
$150,000	($150,000−$83,400=$66,600; $66,600X0.20=$13,320)	+13,320

This exclusion would give a substantial break to the overwhelming portion of taxpayers whose incomes are below the FICA base. It would have the effect of imposing a surtax on the earnings of taxpayers with incomes in excess of the FICA base. So although the Kemp-Kasten proposal would provide for a single nominal flat tax rate of 24 percent for all income levels, as far as income from employment is concerned the exclusion would have the effect of creating two tax rates—19.2 percent for taxpayers with incomes of $41,700 or less, and 28.8 percent for those with incomes above $41,700. For people below the FICA base, income from investments would be taxed at a greater rate (24 percent) than income from earnings (19.2 percent), while the reverse would be true for taxpayers with incomes in excess of the FICA base.

The Kemp-Kasten bill would reduce the taxation of social security benefits somewhat by taxing only one-quarter of amounts in excess of the base amount ($25,000 for single returns and $32,000 for joint returns) rather than one-half as under present law. Kemp-Kasten, like Bradley-Gephardt, would permit the deduction of medical expenses only if they exceed 10 percent of AGI. Non-business interest deductions would be permitted only on loans taken out to pay for educational expenses of the taxpayers or their dependents. Kemp-Kasten is the only alternative that would retain the deduction for legal expenses associated with the adoption of children with special needs. Deductions would be permitted as under present law for all home mortgage interest and real property taxes, but the deductions for personal property taxes, state and local sales and income taxes would be repealed.

The personal exemption for each individual in the tax filing unit would be doubled to $2,000 in 1986 and the extra exemption for taxpayers over age 65 and for blind taxpayers would be set at that amount also. The zero bracket amounts in 1986 would be pegged at $3,300 for joint returns ($410 less than present law), and $2,600 for single taxpayers ($90 less than present law), and $3,200 for heads of household ($690 more than present law). Under the bill, the personal exemption and zero bracket amounts are indexed for cost-of-living increases, with the Secretary of the Treasury prescribing such adjustments not later than December 15 of 1985 for the following calendar year. However, the sponsors indicate that the bill's general effective date, taxable years beginning after December 31, 1985 is intended to take precedence so that the first "indexed" year will be 1987. Therefore, in the analyses that follow, the personal exemption and zero bracket amounts for 1986 are those indicated in the bill with no cost-of-living adjustment taken into account.

Single heads of household would get a major assist under the Kemp-Kasten zero bracket arrangement. Instead of using the zero bracket for single taxpayers as under present law, they could claim a zero bracket of $3,200, only $100 less than the $3,300 for joint returns. The zero bracket arrangement would have the effect of perpetuating part of the present law marriage penalty. Two single taxpayers with $2,600 zero brackets apiece (for a total of $5,200) would have a zero bracket of only $3,300 between them if they married—a $1,900 loss. (Bradley-Gephardt, by comparison, would eliminate the part of the marriage penalty which results from the zero bracket by providing a $6,000 zero bracket for couples which is exactly double the $3,000 provided for singles.)

The Kemp-Kasten earned income credit introduces several new concepts: differentiation of the credit according to the number of individuals in the household, payment of the credit to childless individuals, use of the social security payroll tax rate to compute the credit, and phase-out of the credit at income levels lower than the tax threshold. The credit would be based on $4,500 for one individual, $5,000 for two, and $5,500 for three or more. The statements of the bill's sponsor describing this provision (Congressional Record, April 29, 1985, page H 2679) and the bill itself do not agree regarding how the earned income credit is to be structured. The bill provides that the differentiated amounts would apply according to how many dependents the taxpayer could claim under Sec. 151(e)—children who are under 19 or who are students, or other dependents (such as parents) whose gross income is less than $1,000. The statement in the Record and discussions with staff indicate that it was intended to apply the differentiated amounts according to how many individuals were in the taxpayer's household. Thus, following the Record statement, a couple with one child would use the $5,500 amount which applies in the case of three or more dependents, while following the bill would have limited the same couple to $4,500 based on their one dependent child. Permitting a taxpayer who lives alone or who does not have a child under 19 in the household to qualify for the earned income credit would break further new ground since, under present law, only taxpayers supporting children who live in the taxpayer's household can qualify for the credit. (Because of the confusion between the bill's language and the sponsor's intentions, the calculations in the examples that follow will follow the sponsor's stated intentions. A married couple with two children will use the $5,500 amount for three or more individuals while the single mother with one child will use the $5,000 amount for two individuals.) Because the earned income credit was originally motivated, at least in part, by a desire to offset the social security payroll tax paid by poor working families, Kemp-Kasten would increase the credit rate from 11 percent under present law to the social security payroll tax rate on both employer and employee—14.3 percent in 1986. The phase-out rate would be increased from 12.2 percent under present law to 15 percent. This steeper phase-out would reduce the earned income credit to zero at an income level lower than the income tax threshold. Under this approach, the entire amount of the credit paid would always be "refundable"; it would never offset positive tax liability as is the case under present law and several of the other alternatives. The sponsor's intent was to avoid the steep marginal tax rates on low income individuals and families that would occur if they were subjected to both the earned income credit phase-out rate and the flat tax rate.

TREASURY

The Treasury proposal would increase the personal exemption to $2,000 in 1986 and repeal the additional exemption for taxpayers who are over age 65 or blind. The proposed zero bracket amounts for heads of household would be raised to $3,500, a level closer to that for joint returns ($3,800) than that for singles ($2,800). This would result in an $1,800 difference in zero brackets for two single taxpayers compared with a married couple, almost $500 more than under present law. The additional exemption for elderly or blind taxpayers, which under present law is available regardless of income, would be repealed; however, it would be replaced by an expanded credit for the elderly and disabled which would be targeted to low-income taxpayers.

The Treasury proposal would use three brackets which would apply to taxpayers according to their family status. These rates of 15, 25, and 35 percent are close to the proposed Bradley-Gephardt marginal rates. However, the Treasury proposal would apply all three rates to taxable income instead of levying a normal tax and surtax on different tax bases as Bradley and Gephardt propose.

Thus, under the Treasury proposal, deductions would be worth 15, 25 or 35 cents on the dollar, depending on the taxpayer's income.

The Treasury proposal would eliminate the exclusion of all but the core employee benefits and would limit the exclusion of health insurance benefits to employers' payment only up $70 per month for individual coverage and $175 per month for family coverage (both amounts indexed). The deduction for contributions to IRA's would be increased to $2,500 per taxpayer. This would have the effect of creating a spousal IRA since a couple could deduct $5,000 provided their earnings exceeded that amount, regardless of how much of the aggregate compensation was generated by either spouse. The deduction for charitable contributions would be limited to contributions in excess of two percent of the AGI. Interest income and interest expenses would be netted and indexed for inflation beginning in 1989, with two exceptions. Mortgage interest on the taxpayer's principal residence would be fully deductible. The first $5,000 of interest expense would not be subject to indexing. The deduction for state and local income, sales and property taxes would be limited to 50 percent in 1986 and eliminated thereafter. The dependent care credit would be repealed and converted to a deduction for both itemizers and non-itemizers up to maximum of $2,400 for one dependent and $4,800 for two or more.

SILJANDER AND DECONCINI

The Siljander and the DeConcini proposals represent two opposite ends of the "pure" flat tax spectrum. Each would impose one single tax rate on all AGI: 10 percent under Siljander, 19 percent under DeConcini. Neither proposal would include a zero bracket amount. The Siljander personal exemption would be about double that of present law. The DeConcini personal exemptions, in contrast, would be $9,450 for a married couple, $8,400 for a head of household, and $4,750 for a single person. These amounts would be large enough to offset substantially the lack of a zero bracket amount. They also would eliminate a marriage penalty and provide some assistance to heads of household.

The Siljander proposal, in an attempt to broaden the tax base enough to make a 10 percent tax rate possible, would repeal the exclusion of most employee benefits including health insurance.

DeConcini, in contrast, would exclude "goods and services provided to employees, including but not limited to medical benefits, insurance, meals, housing, recreational facilities and other fringe benefits." However, since the bill would not permit employers to deduct the cost of providing these benefits, there appears to be little likelihood that the bill would trigger a dramatic shift from cash compensation to in-kind benefits. In addition, employees would probably desire to receive as much of their compensation in cash as possible since the bill repeals most of the familiar deductions for items such as medical expenses, charitable contributions, mortgage and other interest payments, state and local taxes, and IRA contributions. DeConcini as drafted, does not address how to treat transfer payments. Therefore, for purposes of the calculations that follow, it is assumed that social security and unemployment compensation are included in income since they are based on employment, while food stamps, energy assistance and child support are excluded since they cannot in any way be considered to be employment income.

TEN FAMILIES

The impact of the proposals just described can be seen by calculating the tax outcome for families in different circumstances. There are countless possible comparisons that could be made in order to highlight particular aspects of these proposals. The approach used here is ten case studies. Hypothetical taxpaying families and single women are described, primarily in terms of their tax-relevant characteristics. Most of these taxpayers are broadly representative of segments of our population. A few are included because the highlight particularly interesting situations with relevance to issues regarding women living alone or in families.

The first two families represent the old and the new versions of the "average" family. Indeed, the first example may well be the prototypical American family today. Both Ann and Bill work, earning about the median wage for a dual-earner couple to support their two children and their new home. Cathy and Dave, the second family, are pursuing a course more common in the 1950's than today: a young couple living solely on the husband's income with the wife looking after their four children at home.

Several families under varying degrees of financial hardship are also included. Ellen and Frank's circumstances are identical to Ann and Bill's except that they are paying high mortgage interest rates and live in an area where state and local property and income taxes are much higher than average.

Three families in varying degrees of financial distress are included. Gwen and Hal's circumstances are identical to Ann and Bill's except that Hal has become unemployed and the family's income has been cut back to primarily Gwen's earnings and Hal's unemployment compensation. Irene and Jack are living somewhat below the official poverty level, despite both of their work efforts and that of one of their two daughters. Karen, a single mother with one child, is also included.

Because higher income taxpayers are more likely to be dramatically affected by loophole closing and restructuring of the tax system, two examples were included: Linda, a single women, and Mary and Nick, a couple who both pursue successful professional careers.

Finally, families and women at the older end of the age continuum are represented by a recently retired couple in their early- to mid-sixties, Olive and Paul, and by Ruth, an elderly widow with only a small social security benefit.

These families each are described more fully in Appendix 1. Their financial circumstances are listed first in terms of 1986 values. Then the same families' financial circumstances are calculated subject to 25 percent inflation. This much inflation could occur in a very short time, as was the case in 1979 and 1980 when prices increased 26.3 percent, or it could require up to eight years under conditions such as the years 1954 to 1962. The families are not "aged," that is, there are no assumptions that children will grow older or that parents will get job promotions, accumulate assets or pay off mortgages. Also, they are not assumed to have adjusted their spending or savings habits in response to the incentives built into the various tax alternatives. Instead, the families simply are shifted upwards 25 percent on the consumer price index and portrayed as if they had come along at a time when prices were higher. This is done in order, first, to illustrate the impact of tax indexing and second, to permit any phase-in or phase-out provisions of the various proposals to have had time to take effect.

The tax returns for each family or woman are calculated under the provisions of present law and the five proposals. These calculations are made for two points in time—1986 and a later time after 25 percent inflation has occurred. Where necessary, the second "snapshot" is assumed to have occurred after all the proposals are fully effective. To facilitate comparison, the tax proposals and present law have been indexed up to 1986 levels by assuming 4 percent CPI increase in 1984 and 5 percent in 1985, the estimates used in the Treasury proposal. Appendix 1 contains details of these calculations.

None of the calculations includes items relating to retirement contributions other than IRA, Keogh and 401(k) plans.

IMPACT OF ALTERNATIVES ON FAMILIES' TAXES

(1) HIGHER TAXES OR LOWER?

The first question most voters are concerned with is, quite simply, will this proposal raise or lower my taxes? Frequently accompanying this concern is the conviction that one's own taxes will increase while everyone else's—and particularly those of wealthier taxpayers—will decrease.

Chart 2 summarizes the results of present law and the tax proposals for the ten families and women.

CHART 2.—IMPACT OF PRESENT LAW AND ALTERNATIVES ON TAXES OF FAMILIES AND WOMEN, 1986

Taxpayers	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Family 1—Ann and Bill—2 earners, 2 children, $35,230:						
Tax	$2,728	$2,960	$3,331	$2,705	$2,065	$4,136
Change		+232	+603	−23	−663	+1,408
Percent change		+9	+22	−1	−24	+52
Family 2—Cathy and Dave—1 earner, 4 children, $23,098:						
Tax	$1,522	$1,497	$684	$1,063	$622	$1,138
Change		−17	−838	−459	−852	−384
Percent change		0	−55	−30	−44	−25
Family 3—Ellen and Frank—same as family 1 but high housing and tax expenses, $35,230:						
Tax	$1,933	$2,578	$2,503	$2,322	$1,680	$4,163
Change		+645	+570	+389	−253	+2,203
Percent change		+33	+29	+20	−13	+115
Family 4—Gwen and Hal—same as family 1 but husband unemployed $21,000:						
Tax	$1,067	$1,817	$2,212	$1,683	$967	$2,284
Change		+750	+1,145	+618	−98	+1,219
Percent change		+70	+107	+58	−9	+114

CHART 2.—IMPACT OF PRESENT LAW AND ALTERNATIVES ON TAXES OF FAMILIES AND WOMEN, 1986—Continued

Taxpayers	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Family 5—Irene and Jack—2 earners, 2 children, poverty level, $10,300						
Tax	$94	−$116	−$376	−$153	$159	$0
Change		−210	−470	−247	+65	−94
Percent change		−223	−500	−263	+69	−100
Family 6—Karen—single mother, 1 child, $11,785:						
Tax	$409	$698	$688	$530	$678	$230
Change		+289	+259	+121	+269	−179
Percent change		+71	+63	+30	+65	−44
Family 7—Linda—single woman, $35,500:						
Tax	$2,955	$3,534	$3,024	$3,442	$1,908	$5,752
Change		+579	+69	+487	−1,047	+2,797
Percent change		+20	+2	+16	−35	+95
Family 8—Mary and Nick—affluent couple, $83,500:						
Tax	$8,654	$11,692	$7,519	$10,908	$5,025	$14,735
Change		+3,038	−1,135	+2,254	−3,629	+6,081
Percent change		+35	−13	+26	−42	+70
Family 9—Olive and Paul—retired couple, high medical expenses, $25,600:						
Tax	$569	$420	$696	$839	$688	$2,597
Change		−149	+127	+269	+119	+2,027
Percent change		−26	+22	+47	+21	+355
Taxpayer 10—Ruth—widow, $5,500:						
Tax	$0	$0	$0	$0	$0	$0
Change						
Percent change						

AFTER 25 PERCENT INFLATION

Taxpayers	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Family 1—Ann and Bill—2 earners, 2 children, $44,000:						
Tax	$3,411	$4,688	$4,359	$3,537	$2,581	$5,170
Change		+1,277	+948	+126	−830	+1,759
Percent change		+37	+28	+4	−24	+52
Family 2—Cathy and Dave—1 earner, 4 children, $28,875:						
Tax	$1,901	$2,334	$958	$1,359	$827	$1,423
Change		+433	−943	−542	−1,074	−478
Percent change		+23	−50	−29	−56	−25
Family 3—Ellen and Frank—same as family 1 but high housing and tax expenses, $44,000:						
Tax	$2,414	$4,014	$3,129	$3,355	$2,100	$5,170
Change		+1,600	+715	+941	−314	+2,756
Percent change		+66	+30	+39	−13	+114
Family 4—Gwen and Hal—same as family 1 but husband unemployed $30,000:						
Tax	$1,805	$2,664	$2,868	$2,104	$1,444	$2,855
Change		+859	+1,063	+299	−361	+1,050
Percent change		+48	+59	+17	−21	+58
Family 5—Irene and Jack—2 earners, 2 children, poverty level, $12,875:						
Tax	$262	$221	−$538	−$191	$198	$0
Change		−41	−800	−453	−64	−262
Percent change		−16	−305	−173	−24	−100
Family 6—Karen—single mother, 1 child, $15,700:						
Tax	$757	$1,075	$911	$655	$941	$287
Change		+318	+154	−102	+184	−470
Percent change		+42	+20	−13	+24	−62

AFTER 25 PERCENT INFLATION—Continued

Taxpayers	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Family 7—Linda—single woman, $44,375:						
Tax	$3,694	$5,322	$3,780	$4,709	$2,436	$7,190
Change		+1,638	+86	+1,015	−1,258	+3,496
Percent change		+44	+2	+27	−34	+95
Family 8—Mary and Nick—affluent couple, $103,375:						
Tax	$11,063	$16,577	$9,420	$15,102	$6,386	$18,418
Change		+5,514	−1,643	+4,039	−4,677	+7,355
Percent change		+50	−15	+37	−42	+66
Family 9—Olive and Paul—retired couple, high medical expenses, $32,025:						
Tax	$720	$882	$1,019	$976	$859	$3,247
Change		+162	+299	+256	+139	+2,527
Percent change		+23	+42	+36	+19	+351
Taxpayer 10—Ruth—widow, $6,875:						
Tax	$0	$0	$0	$0	$0	$0
Change						
Percent change						

Chart 2 shows that both in 1986 and after 25 percent inflation, the various alternatives produced markedly different results for the ten tax returns. Ann and Bill, the median income two-worker family, had a small increase under the Bradley-Gephardt proposal and none under the Treasury's. Under Bradley-Gephardt, this was because they retained their deductions for most of their taxes and mortgage and continued to get some relief, although reduced, on their dependent care expenses. The large zero bracket and increased personal exemptions and the 14 percent flat rate nearly offset the loss of the two-earner and other deductions and the inclusion of employee benefits. The effects of the Treasury proposal in 1986 were similar to those under Bradley-Gephardt. In the later "snapshot," however, taxes were higher under both Bradley-Gephardt and Treasury than under present law. The total elimination of all deductions for state and local, income, property and sales taxes under the Treasury plan resulted in a $126 increase (4 percent) over present law, while the lack of indexation boosted the family's taxes $1,277 (37%) above their present law liability. The Kemp-Kasten proposal resulted in a $603 (22 percent) tax increase in 1986 for the two-earner family. The exclusion of $7,000 of their earnings and the doubled personal exemptions were not quite enough to offset the loss of the dependent care tax credit and the deductions for two-earners, income and sales taxes and consumer interest. Also, their entire taxable income was taxed at 24 percent instead of the graduated 11, 12, 14, 16, 18 and 22 percent rates under present law. Siljander reduced Ann and Bill's taxes substantially. Although health insurance costs were included in income, the couple continued to benefit fully from all their deductions rather than only those in excess of the zero bracket amount as under present law. The personal exemption was doubled. The flat 10 percent tax on the resulting low amount of taxable income further benefited them; they would have to have paid at a 13.2 percent rate to match their tax under present law. The DeConcini proposal imposed the largest tax increase on the couple. Adjusted gross income was increased by repeal of the IRA and two-earner deductions, and the only deduction from AGI was the large personal exemption.

Ellen and Frank, whose financial profile is identical to Ann and Bill's except that they have higher housing and tax costs, had lower taxes than Ann and Bill under all the options except DeConcini which denied interest and tax deductions to both couples. Under present law, their taxes were $2,414 or 29 percent less than Ann and Bill's in the second "snapshot." This considerable subsidy for housing and taxes was rivaled only under Kemp-Kasten which levied taxes that were $1,230 or 28 percent lower for Ellen and Frank than for Ann and Bill. Under Bradley-Gephardt, there was only a $674 differential (14 percent) between the two couples' taxes; under Treasury there was only $182 difference (5 percent) between their liabilities; and under Siljander the difference was $487 (18 percent). As would be expected, these diminished "housing subsidies" resulted in tax increases for Ellen and Frank under the various alternatives that were substantially greater than the increases for Ann and Bill.

Gwen and Hal, a quarter of whose income consisted of unemployment compensation, also paid substantially more—from 58 to 237 percent more—under all alternatives but one (Siljander). This occurred primarily because while present law and Siljander include income from unemployment compensation only to the extent that total income exceeds a threshold amount, the other five alternatives count all unemployment compensation as income regardless of the level of total family income.

Cathy and Dave and their four children fared well under all the alternatives. Their tax cuts in 1986 ranged from less than one percent under Bradley-Gephardt to 55 percent under Kemp-Kasten. The large personal exemptions and zero bracket amounts equaled 60 percent or more of their income under the five alternatives. The 20 percent earnings exclusion under Kemp-Kasten reduced this family's taxes substantially and more than compensated for the elimination of various itemized deductions and the imposition of a flat 24 percent flat rate.

The poverty-level family of four headed by Irene and Jack paid $94 under present law in 1986 and $262 after 25 percent inflation had occurred. This increase occurred because the non-indexed earned income credit, which only offset four-fifths of their tax liability in 1986 was not available to them at all at their "second snapshot" income level. The results were similar under Bradley-Gephardt. Irene and Jack fared best under the Kemp-Kasten proposal. Here they got the advantage of the 20 percent employment income exclusion, plus the doubled personal exemptions and a more generous EITC which indexed both dollar amounts and the tax rate. The Treasury proposal reduced the couple's taxable income by about $5,000 and provided a more generous, indexed earned income credit which paid them a refund in both years, although not as generous as that under Kemp-Kasten. Neither of the two "pure" flat tax approaches retained the earned income credit. Under Siljander, this resulted in a positive tax liability for this poverty-level family, but under DeConcini, the huge personal exemptions exceeded the poverty level and protected the family from positive tax liability.

Ruth, the widow on social security, was the other very low income taxpayer in the sample of ten. She owed income tax only under the DeConcini proposal; this was due to the inclusion of all social security benefits as income under that plan.

The single mother had a tax increase under all but one of the proposals. This occurred in large part because $1,000 of her $12,500 income was unemployment compensation which is partially excluded under present law. If her income had been comprised of $12,500 exclusively in wages, her tax under present law would have been $548 rather than $409. (This results from both a higher initial tax and a smaller dependent care credit based on a higher AGI.) The tax alternatives increased her tax above the $548 level, but by not as great an amount as when unemployment compensation was part of her income. These non-unemployment compensation-related increases under the Bradley-Gephardt and Treasury proposals are related largely to the different treatment of $1,500 of dependent care expenses compared to present law. These two proposals convert the credit, which under present law is worth 28 percent or $420, to a deduction which under Bradley-Gephardt is worth 14 percent or $210 and under the Treasury proposal is worth 15 percent or $225. The Kemp-Kasten proposal eliminates any tax consideration of dependent care expenses, but this is more than compensated by the 20 percent exclusion of employment income. The DeConcini proposal similarly ignores dependent care expenses but compensates by allowing a $10,290 personal exemption rather than the $2,180 under present law. The Siljander alternative results in substantially higher taxes because there are no offsetting features to compensate for the elimination of special treatment of dependent care expenses.

Linda, the career woman, paid a higher tax under all the alternatives except the Siljander proposal which preserved all her deductions and imposed a flat rate of only 10 percent. DeConcini resulted in the highest tax because all deductions were eliminated and a 19 percent flat rate was imposed on a substantially higher taxable income. The Treasury proposal increased her taxes by about a quarter by increasing taxable income through loss of deductions for retirement, savings, taxes and interest. Her taxes were nearly unchanged under Kemp-Kasten. The 20 percent earnings exclusion reduced her taxable income but the flat 24 percent rate produced a tax liability about equal to present law. She would have fared better under Bradley-Gephardt if she had had more interest income to balance her interest deductions in the surtax range.

Mary and Nick, the affluent couple, paid higher taxes under all the alternatives except Siljander and Kemp-Kasten. The former eliminated $9,500 of adjustments but levied a tax at only the 10% flat rate rather than the 11 to 33 percent rates used under present law. The large Kemp-Kasten employment income exclusion reduced their taxable income 21 percent; this was partially offset by the 24 percent flat rate, resulting in a 13–15 percent tax reduction. Limiting deductions to only the 14 percent base tax under Bradley-Gephardt resulted in a $3,038 tax increase in 1986 for the couple under this plan and even more after 25 percent inflation. The

Treasury and DeConcini plans also pared their deductions resulting in substantial tax increases despite lower marginal rates.

The retired couple, Olive and Paul, had lower taxes under only the Bradley-Gephardt proposal. Its increased standard deduction reduced their taxable income from $8,600 to $3,000 while the tax rate was about the same as under present law. Under Kemp-Kasten, the 20 percent employment income exclusion and the doubled personal exemptions, including an additional exemption for an over-65 taxpayer were not large enough to prevent the 24 percent tax rate from increasing their liability. The DeConcini plan resulted in the highest tax—a 446 percent increase—because social security benefits were included in income. The Treasury proposal increased the couple's taxes by $271, or 48 percent, by limiting their itemized deductions and increasing their tax rate to 15 percent. Siljander's lower tax rate, 10 percent, failed to reduce their tax because they lost the medical expense deduction as well as the zero bracket.

Summing up the results proposal by proposal, Bradley-Gephardt increased taxes by about 70 percent in 1986 for both the family experiencing unemployment and the single mother and imposed substantial tax increases on the family with high housing and tax expenses and on the affluent couple. The poverty-level family and the retired couple had tax reductions in 1986 under Bradley-Gephardt while the two-earner couple in average circumstances and the one-earner family of six experienced little change. The others had no changes or a small tax reduction. Kemp-Kasten produced substantial tax increases for the family experiencing unemployment, the retired couple, and the single mother, while cutting taxes significantly for the family of 6, the poverty-level family and the affluent couple. After 25 percent inflation, the Treasury plan increased taxes the most for the two-earner family with high housing and tax expenses (47 percent), the affluent couple (37 percent), the retired couple (36 percent), and the single woman (27 percent). It reduced taxes for the family of six and the single mother and gave a larger earned income credit to the poverty-level family. The two-earner family of four with moderate housing and tax expenses experienced only a small increase. DeConcini raised taxes for all except the family of six and the poverty-level family. Siljander cut taxes for most of the taxpayers but produced an increase for the retired couple and the single mother and eliminated the earned income credit for the poverty-level family.

(2) INDEXING

If all the taxpayers experienced an across-the-board 25 percent increase in all income and expenditure amounts, a totally indexed proposal would result in a 25 percent increase in their tax liability as well. As chart 3 shows, however, this was not the case for most of the alternatives.

CHART 3.—PERCENT CHANGE IN TAX LIABILITY BETWEEN 1986 AND AFTER 25 PERCENT INFLATION

Taxpayer	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
1	25	50	31	31	25	25
2	25	56	53	28	25	25
3	25	56	25	44	25	25
4	69	47	26	40	49	25
5	178	290	−43	−25	25	([1])
6	85	54	36	24	39	25
7	25	51	25	37	28	25
8	28	42	25	38	27	25
9	27	110	46	16	25	25
10	([1])	([1])	([1])	([1])	([1])	25

[1] Paid no tax in either year.

Only the DeConcini plan produced fully indexed results. The Siljander proposal resulted in about a 25 percent increase in tax liability in all but two instances. Because Siljander retains the current law treatment of unemployment compensation which is based on an unindexed fixed dollar base amount, a relatively greater portion of unemployment compensation was included in the "after 25 percent" computation than in the 1986 for the two families experiencing unemployment. The affluent professional couple and the single woman were unable to increase their IRA contributions beyond the amounts contributed in 1986 because of the statutory cap. Except for these factors, the Siljander proposal was fully indexed. (The cap on IRA contributions affected the affluent couple and the career woman under all the proposals except the Treasury plan which increased the cap by 25 percent and the DeConcini plan which repealed IRA's altogether. However, where alternative tax-advantaged savings were permitted, these taxpayers were assumed to have put their "excess" IRA contributions into these plans.)

The Treasury proposal produced a greater than 25 percent increase because half the amount of state and local taxes could be deducted in 1986 while none of these taxes were deductible thereafter and because interest income and expenses were fully includable or deductible in 1986 but were indexed for inflation in the second "snapshot."

The Kemp-Kasten plan is described as fully indexed; however, in more instances than not it produced "non-indexed" results among the nine tax returns. Nonitemizing taxpayers who were benefited by the deduction for charitable contributions lost the benefit of this provision after it expired at the end of 1986. This affected families No. 2, 6, and 9. Also, the IRA cap held their tax-deductible savings to the 1986 $4,000 level if they had no other tax-advantaged savings options.

Under present law, only the tax rate brackets and the personal exemption are indexed. Therefore, families were impacted by limitations such as the unemployment compensation base amount (families 4 and 5), the earned income credit fixed-dollar limits (family 4), the dependent care credit fixed-dollar caps and brackets (families 4 and 5), the IRA cap (families 7 and 8), the limitation on the two-earner deduction (family 8), and the fixed-dollar dividend exclusion (family 9). In addition, taxpayers 5 and 6 lost the charitable contribution for non-itemizers which expires at the end of 1986.

The Bradley-Gephardt proposal, as discussed on page 12, was not intended to be indexed. Therefore, all the "after 25 percent" returns show increased tax liability in excess of the 25 percent inflation factor. In all but two cases involving unemployment compensation (families 4 and 6), the increases exceed those that occurred under present law. Thus over time, families and women would see their tax burdens gradually increase as a percentage of their income until tax cuts were enacted.

(3) POVERTY

Three of the ten families had very low incomes. Irene and Jack with their two daughters had income below the official poverty rate. Nevertheless, they owed $94 in federal income taxes in 1986 and $262 after 25 percent inflation because the unindexed earned income credit was insufficient to keep them below the tax threshold. The refundable earned income tax credit (EITC) paid them $116 in 1986 under Bradley-Gephardt but left them with a positive tax liability of $221 in their subsequent tax return because the EITC was not indexed for inflation. The Treasury proposal increased the family's 1986 EITC refund and maintained its value in the subsequent return. Although the Kemp-Kasten EITC has a lower phase-out level than present law, this did not prevent the family from qualifying for and EITC in both years which was the most generous provided under any of the tax alternatives. Neither the Siljander nor DeConcini plans had an EITC. The Siljander tax structure yielded them a tax liability almost as great as under present law. The DeConcini plan's large personal exemptions held their liability to zero in both years.

Karen, the single mother, did not qualify for the EITC under any of the proposals because her income, at 164 percent of the 1986 estimated poverty level for a family of two, exceeded the EITC phaseout amounts. Eligibility for the credit requires having a dependent child, so Ruth, the 82-year-old widow, was not eligible for the EITC regardless of her income level.

Irene and Jack received food stamps and energy assistance payments and Karen and Ruth received food stamps. None of the plans included these amounts as income.

Because Karen's income was relatively low, the conversion of the dependent care credit to a deduction under the Bradley-Gephardt and the Treasury proposals had the effect of increasing her taxes. Under present law she qualified for a 29 percent dependent care credit against these expenses in 1986 and a 27 percent credit after 25 percent inflation. Under Bradley-Gephardt the expenses were deductible only at a 14 percent rate. Similarly, under the Treasury plan, dependent care expenses were deductible for Karen at only a 15 percent rate. Kemp-Kasten, Siljander and DeConcini repealed any allowance for dependent care expenses. Because the dependent care credit under present law provides such a large measure of tax relief to single women heading households, the impact of its elimination or conversion to a credit can be offset only by a major adjustment elsewhere, such as the $10,290 personal exemption provided in the DeConcini plan. Otherwise, the result for single mother families with substantial dependent care expenses will be a tax increase.

Ruth depended on social security, interest, food stamps and her savings exclusively. Present law and most of the proposals excluded her social security benefits and counted only her interest as income. As a result, she incurred no tax liability in either year. DeConcini, however, included her social security in income which resulted in a $52 income tax in 1986 and $65 after 25 percent inflation.

The key components of the tax alternatives for keeping poverty-level families and women below the tax threshold are the personal exemptions, the zero bracket amounts and earned income credits. The tax thresholds in 1986 for various families and individuals under the tax alternatives are as follows:

CHART 4.—TAX THRESHOLDS FOR TAXPAYERS UNDER PRESENT LAW AND ALTERNATIVES

	Est. 1986 poverty level [1]	Present Law	Bradley-Gephardt	Kemp-Kasten	Treasury [2]	Siljander	DeConcini
Single elderly person	$5,428	$4,690	$5,600	$8,250	$6,800	$2,100	$4,725
Single nonelderly person	5,886	3,600	3,600	5,750	4,800	2,100	4,725
1 parent, 1 child	7,608	7,979	8,224	9,000	9,309	4,200	10,290
1 parent, 2 children	9,025	8,523	8,758	11,500	10,405	6,300	12,180
2 parents [3], 1 child	9,025	9,096	10,573	11,625	10,570	6,300	11,340
2 parents [3], 2 children	11,565	9,613	11,200	14,125	11,800	8,400	13,230

[1] 1984 poverty level increased by 4 percent for 1984 and 5 percent for 1985.

[2] Assumes a 1985 CPI increase of about 5 percent.

[3] Assumes one earner.

Assuming earned income at 100 percent of poverty earned by one worker and use of the standard deduction, the tax alternatives produce the following tax liabilities:

CHART 5.—FEDERAL INCOME AND PAYROLL TAX ON INCOME AT 100 PERCENT OF POVERTY LEVEL IN 1986

	Present Law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Non-elderly single ($5,886):						
Federal income tax	$262	$180	[1] −$410	$163	$378	$221
FICA	$421	$421	$421	$421	$421	$421
Tax as percent of income	11.6	10.2	0	9.9	13.6	10.9
Single elderly person ($5,428):						
Federal income tax	0	0	[1] −$504	0	$333	$134
FICA	7.2	7.2	−2.1	7.2	13.3	9.6
Tax as percent of income	$388	$388	$388	$388	$388	$388
1 Parent/1 child ($7,608):						
Federal income tax	−$88	−$161	−$323	−$466	$340	0
FICA	$544	$544	$544	$544	$544	$544
Tax as percent of income	6.0	5.0	2.9	1.0	11.6	7.15
2 Parents 2 children ($11,565):						
Federal income tax	$397	$51	0	0	$316	0
FICA	$827	$827	$827	$827	$827	$827
Tax as percent of income	10.6	7.6	7.2	7.2	34.5	7.15

[1] Assumes Kemp-Kasten would permit childless individuals to qualify for the earned income credit.

FEDERAL INCOME AND PAYROLL TAX ON INCOMES AT 125 PERCENT OF POVERTY LEVEL IN 1986

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Non-elderly single ($7,359):						
Federal income tax	$468	$386	[1] $93	$384	$526	$500
FICA	$526	$526	$526	$526	$526	$526
Tax as percent of income	13.5	12.4	8.4	12.4	14.3	13.9
Single elderly person ($6,785):						
Federal income tax	0	$166	[1] −$301	0	$467	$391
FICA	$485	$485	$485	$485	$485	$485
Tax as percent of income	7.2	9.6	2.7	7.2	14.0	12.9
1 Parent/1 child ($9,510):						
Federal income tax	$378	$377	$60	$119	$531	0
FICA	$680	$680	$680	$680	$680	$680
Tax as percent of income	11.1	10.7	7.8	8.4	12.7	7.2
2 Parents 2 children ($14,456):						
Federal income tax	$780	$455	$64	$398	$605	$242
FICA	$1,034	$1,034	$1,034	$1,034	$1,034	$1,034
Tax as percent of income	12.5	10.3	7.6	9.9	11.3	8.8

[1] Assumes Kemp-Kasten would permit childless individuals to qualify for the earned income credit.

(4) EQUITY CONSIDERATIONS AND SPECIAL CONCERNS

Relative position.—All of the tax alternatives consistently yielded the lowest tax liability for the poverty level taxpayers (families 5 and 10) and the highest for the affluent professional couple (family 8). However, as Chart 6 shows, the tax alternatives produced different rank orderings in tax liability in 1986 among the other tax returns. Thus people might find that where their taxes used to be higher or lower than their neighbor's the reverse is true under the alternative proposals.

CHART 6.—RANK ORDER OF 1986 TAX LIABILITIES

[1 = lowest, 10 = highest]

		Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
(1)	Ann and Bill—$35,230: 2 earners, 2 children	8	8	9	8	9	7
(2)	Cathy and Dave—$23,098 1 earner, 4 children	6	5	3	5	3	4
(3)	Ellen and Frank—$35,230: High housing and tax	7	7	7	7	7	8
(4)	Gwen and Hal—$21,000: Unemployment	5	6	5	6	6	5
(5)	Irene and Jack—$10,300: Poverty	2	1	1	1	2	1
(6)	Karen—$11,785: Single mother	3	4	3	3	5	3
(7)	Linda—$35,500: Career woman	9	9	8	9	8	9
(8)	Mary and Nick—$83,500: Affluent couple	10	10	10	10	10	10
(9)	Olive and Paul—$25,600: Retired couple	4	3	5	4	4	6
(10)	Ruth—$5,500: Widow	1	2	2	2	1	1

Karen, heading the single-parent family (6) with about $12,500 of income and $1,500 of dependent care expenses, had the third lowest tax liability under present law, Kemp-Kasten, the Treasury and DeConcini proposals. Under Bradley-Gephardt her liability was greater than that of the retired couple with $13,700 of income and Siljander taxed her more than both the family of six with about $23,000 of income and the retired couple. The one-earner family of six also ranked third lowest under Siljander and Kemp-Kasten and fourth lowest under DeConcini compared with sixth lowest out of ten families under present law. The retired couple who paid the fourth lowest taxes under present law paid the fifth lowest under

Kemp-Kasten and the sixth lowest under the DeConcini plan which fully taxed their social security.

ONE- VERSUS TWO-EARNER FAMILIES

Present law, Bradley-Gephardt and Treasury treat two-earner families who have dependent care expenses more favorably than single-earner families with the same income. Present law allows the two-earner family to deduct 10 percent of the first $30,000 in earnings of the spouse who earns the least and provides a 20 to 30 percent credit against dependent care expenses. Each spouse with earnings can also contribute 100% of income up to $2,000 to an IRA while a one-earner couple is limited to $2,250. Under Bradley-Gephardt the two-earner deduction and the dependent care credit are eliminated and dependent care expenses are made deductible in the 14 percent bracket. For the relatively few families with earnings above the FICA base, the Kemp-Kasten proposal applies the 20 percent earnings exclusion separately to each spouse's earnings thereby avoiding a marriage penalty. However, no allowance is made under Kemp-Kasten for work-related dependent care. The Treasury plan permits two-earner couples to deduct their work-related dependent care expenses and unlike the other alternatives, the Treasury plan permits a full IRA contribution by a non-working spouse, thereby benefiting one-earner couples with an ability to save. Siljander retains present law IRA provisions which permit two-earner couples to contribute up to $4,000 but restrict one-earner couples to $2,250 while DeConcini repeals IRA's altogether.

These differences are seen in the tax liabilities of a two-earner couple with $35,000 in wages ($23,000 and $12,000), $2,800 in dependent care and a one-earner couple with $35,000 in wages and no dependent care and maximum IRA contributions up to $4,000 per couple.

CHART 7.—TAX LIABILITY OF 2- AND 1-EARNER COUPLES IN 1986 [1]

	Income	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
A. 2-earners	$35,000	$2,912	$2,380	$3,048	$2,460	$2,260	$4,136
B. 1-earner	$35,000	$4,171	$3,017	$3,468	$2,880	$2,460	$4,136
A/B (percent)	100	70	79	88	85	92	100

[1] Assumes a $23,000/$12,000 earnings split, $2,800 in dependent care for the 2-earner couple, maximum IRA contributions up to $4,000, no itemized deductions, and 2 children.

None of the tax alternatives goes as far as present law in granting tax relief in recognition of the financial and other burdens borne by two-earner couples such as greater work-related expenses including dependent care, less leisure, and fewer services performed in the home compared to one-earner couples. Under present law, the two-earner family's taxes are only 70 percent of the one-earner family's. The other tax alternatives all narrow this difference in percentage terms, and DeConcini closes it entirely by taxing both couples the same. In dollar terms, all of the tax alternatives would reduce the one-earner family's tax liability compared to present law while two of them—Kemp-Kasten and DeConcini—would increase the two-earner family's taxes.

It can be argued that the most relevant way to assess the different tax treatment between one- and two-earner couples is not to compare two families with identical incomes but rather to look at families with and without the income of the lesser-earner. This is the comparison actually made by two-earner couples trying to decide whether one parent should stay at home with their children. Chart 8 compares the same couple as shown on line A in Chart 7 before and after the lesser-earner leaves the work force. Again this example assumes the maximum IRA contribution up to $4,000. Since this is probably an unrealistic contribution for a family earning $23,000 the chart also shows the same situation without any IRA contributions for either family.

CHART 8.—1986 TAX LIABILITY FOR 1- AND 2-EARNER FAMILIES [1]

Taxpayer	Income	Present law	Bradley-Gephart	Kemp-Kasten	Treasury	Siljander	DeConcini
With IRA Contributions up to $4,000:							
A. 2-earners	$35,000	$2,912	$2,380	$3,048	$2,460	$2,260	$4,136
B. 1-earner	$23,000	$1,729	$1,337	$1,164	$1,343	$1,235	$1,856
B/A (percent)	66	59	56	38	55	55	45
Without IRA contributions:							
A. 2-earners	$35,000	$3,314	$2,940	$4,008	$3,060	$2,660	$4,136
B. 1-earner	$23,000	$2,112	$1,652	$1,704	$1,680	$1,460	$1,856
B/A (percent)	66	64	56	43	55	55	45

[1] Assumes a $23,000/$12,000 earnings split for the 2-earner family, $2,800 in dependent care, maximum IRA contributions where indicated up to $4,000, no itemized deductions and 2 children.

It is clear from Chart 8 that the Kemp-Kasten proposal gives the greatest advantage to one-earner families compared to two-earner families. In this example, the one-earner family—similar to Cathy and Dave, but with only two children rather than four—has 66 percent of the income of their two-earner neighbors, Ann and Bill. However, under Kemp-Kasten, the one-earner family pays a tax only 38 to 43 percent as large as the two-earner family. For them, this compares favorably with present law which taxes them at a level equal to 59 to 64 percent of their two-earner neighbors. Their tax under Kemp-Kasten is actually lower in dollar terms than their tax under present law while the two-earner family's taxes are higher than under present law. The Bradley-Gephardt, Treasury and Siljander plans also give the one-earner family some advantage over present law, but not as much as Kemp-Kasten. The DeConcini proposal increases the two-earner family's taxes more substantially than does Kemp-Kasten; the result is that the $23,000 family's taxes are only 45 percent of the $35,000 family's.

It is difficult to sum up this mixed picture. Bradley-Gephardt and Siljander treat two-earner families with dependent care expenses better than the other proposals in both their absolute taxes and their taxes in relation to one-earner families with two-thirds as much income. Treasury runs a close third in this comparison. All three result in tax cuts for both families. One-earner families fare best under Kemp-Kasten compared to the two earner families; however, this is due to both the increased taxes paid by two-earner families and the decreased taxes owed by one-earner families.

MARRIAGE PENALTY

A different aspect of the one-earner versus two-earner issue is the marriage penalty. The aggregation of a couple's earnings for income tax purposes, the progressive tax structure, and the different rate schedules for taxpayers with different martial statuses frequently combine under present law to impose a higher tax burden on two workers married to each other than on two single workers with the same incomes. The deduction available under present law to two-earner couples—equal to 10 percent of the lower-earner's first $30,000 of income—was intended to ameliorate this penalty. It accomplished its purpose at lower income levels, but a substantial marriage penalty still remains for couples with closely-matched above-average incomes.

Taxpayer No. 7, Linda, has an income of $35,000 in wages plus employee benefits and interest. If she married a co-worker with an identical income and they made no changes in their spending patterns, the results would be the following:

CHART 9.—MARRIAGE PENALTY

Taxpayer	Income	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
A. "singles" returns:							
Linda	$35,500	$2,955	$3,534	$3,024	$3,442	$1,908	$5,752
Linda's fiancee	35,500	2,955	3,534	3,024	3,442	1,908	5,752
Totals	71,000	5,910	7,068	6,048	6,884	3,816	11,504
B. Joint return: Linda plus husband	71,000	5,931	8,267	6,048	7,384	3,817	11,504
C. Difference before and after marriage	0	+21	+1,199	0	+500	0	0

Under present law, the couple pays a tiny $20 marriage penalty. Although they moved from the 20 percent marginal rate to 28 percent and lost $1,310 in zero bracket amount, these disadvantages were more than offset by the $3,000 two-earner deduction. Under Kemp-Kasten, Siljander and DeConcini, their tax was exactly the same married or single. This was because the latter two plans use one tax rate, no zero bracket, and allow personal exemptions for a couple exactly twice the amount allowed for two single individuals. As noted elsewhere, the Kemp-Kasten earned income exclusion is structured to be marriage-neutral for two-earner couples. The marriage penalty effect of the $1,900 discrepancy in the zero brackets for joint and single returns under Kemp-Kasten is negated in this example by the fact that itemized deductions exceed the zero bracket amount. For non itemizers, a marriage penalty of $456.00 results from this difference in zero bracket amounts.

Under Bradley-Gephardt, the couple's combined taxes higher than the taxes they owed while they were single. This occurred because as single taxpayers, only 23 percent of each individual's adjusted gross income was subject to the 12 percent surtax which begins at $25,000 for single taxpayers, while as a married couple, 38 percent of their adjusted gross income was subject to the 12 percent surtax. This effect would disappear for couples whose combined incomes were less than $40,000, the beginning of the joint return surtax range. The standard deduction and personal exemption for couples are exactly double those for singles, thereby avoiding any penalty due to these factors. Under the Treasury proposal, a marriage penalty of $500 was incurred, primarily because of the difference in zero bracket amounts, but some of the penalty is attributable to the rate schedule.

SPECIAL CONCERNS

Personal exemptions: Present law and most of the proposed alternatives allow the same size personal exemption for adults as for children. However, two proposals are unique in that they allow a larger personal exemption for adults than they allow for dependents. Under Bradley-Gephardt, an adult taxpayer and spouse can each deduct $1,600 and a single householder gets an $1,800 personal examption. Children and other dependents, however, qualify for only a $1,000 personal exemption. Similarly, the DeConcini proposal allows $4,500 each for a married couple and $8,400 for a single householder, while children are worth personal exemptions of $1,890 apiece. None of the proposals offered an exemption for children larger than that for their parents.

These variations raise the issue of the purpose exemptions are intended to serve. Exemptions, together with standard deductions or zero brackets, exclude a certain portion of every taxpayer's income from taxation, regardless of the taxpayer's total income. This makes sure that at least a subsistence amount is set aside for consumption. However, right after World War II, when the personal exemption was $600 it was worth considerably more in relative terms than it is today—the equivalent of about $5,600.

Providing larger exemptions for adults than for children may be based on the theory that adults consume more, on average than children (a notion that parents of teenagers might dispute). It may reflect the principle that the adult taxpayers themselves are the principal generators of income and that children are merely subsidiary to the taxpayers.

Where only one or two children are involved, these differences do not produce startling changes in tax liability from plan to plan. But in large families, such as Cathy and Dave's, the differences become noticeable. Cathy and Dave with their four children—a total of six people in their household—are entitled to twice the amount of personal exemptions under present law as they received when they had only one child, or a total of three people in their household. The same two-to-one relationship holds true under the Kemp-Kasten, Treasury, and Siljander proposals. However, under the Bradley-Gephardt proposal, the family of six could exempt only 1.7 times the amount allowed to them as a family of three. The DeConcini proposal has an even more pronounced effect; exemptions for the family of six are only 1.5 times as much as for a family of three.

The tax alternatives use the increased personal exemption as a means of avoiding taxation of poverty-level families. However, as an "anti-poverty" technique, this is a far more expensive approach than other options. The revenues lost for each $100 increase in the personal exemption are estimated to be more than $5 billion. Thus, raising the exemption to $2,000 in 1986 would involve a revenue impact in excess of $50 billion. Other ways to protect poverty-level families from tax liability are increasing the zero bracket amount and increasing the earned income credit. Since the zero bracket amount is not used by itemizers, who are principally in the $25,000 income range and over, increasing it is not as costly as adjusting the personal exemption which affects all tax returns. The least expensive techniques for protecting low-income taxpayers is the earned income credit since it is targeted exclusively on low-income families. If shielding low-income families from federal income taxes were the sole rationale for the increased personal exemptions found in the various alternatives, the $50 billion or so involved could be used in other ways to provide greater benefit to families with less than average incomes or families with children—non-refundable credits, increased exemptions for children or expanded earned income credit, for example. However, as the examples summarized on Chart 2 indicate, the increased personal exemption serves other functions in addition to protecting low-income families.

Dependent care: As has been discussed at several points in previous pages, most of the flat tax proposals eliminate any tax-recognition of work-related dependent care expenses. This creates a particular burden for lower income families who do not have enough disposable income to afford a reasonable quality of care for their children or older incapacitated dependents, particularly if they must rely on the more expensive licensed market rather than using informal and/or unpaid caretakers. Single parents particularly are more likely to need the reliability of a formal dependent care arrangement and are less likely to be able to pay for it. Bradley-Gephardt and Treasury convert the dependent care credit to a deduction available to both itemizers and non-itemizers. Under Bradley-Gephardt, the expenses are deductible only in the 14 percent basic tax bracket; this deduction is worth less than the 20 to 30 percent credit currently available under present law. Under the treasury proposal, dependent care deductions are allowed in all three brackets and are worth 15, 25, or 35 percent depending on the family's income. Treasury estimates that 39 percent of the deductions for dependent care would be claimed by families with incomes over $50,000, exactly the families most likely to have a type of dependent care that constitutes a mixed business/personal expense—live-in nannies, expensive summer camps or specialized preschool development programs. Although it is argued that progressivity should be provided directly through the tax rate structure, the problem nevertheless remains of how lower-income working parents will be able to purchase dependent care, particularly as other direct government subsidies for these services continue to shrink.

Medical expense deductions: The present tax code recognizes that extraordinarily large medical bills impair a family's taxpaying ability. Although this deduction has been pared down in recent years, it still allows expenses which exceed five percent of AGI to be deducted. Only the Treasury plan continues this deduction at its present level; however, repeal of a number of exclusions will have the impact of increasing taxpayers' AGI and therefore raising the level of medical expenses they must have in order to exceed the five percent level. Kemp-Kasten and Bradley-Gephardt increase the threshold to 10 percent of AGI, while Siljander and DeConcini repeal the medical expense deduction altogether. These changes will mean that families devastated by catastrophic, or merely "very high," medical expenses will be expected to pay the same amount of income tax as usual.

Tax base: Central to the flat tax concept is setting as low as possible a tax rate on as wide as possible a tax base. Some of the tax alternatives go further in this direction than others. Several of the flat tax plans propose base broadening that could, if enacted, have significant impact on women and families. Perhaps the most notable is the inclusion of the value of health insurance coverage in income. The Siljander proposal would include the total value of health insurance coverage, while the Treasury plan would include the portion that exceeds an indexed threshold. Despite the inclusion of health insurance costs, the Siljander proposal, with its low tax rate would be less likely to result in a decrease in health insurance coverage, particularly since it allows most of the itemized deductions permitted under present law and therefore results in a substantially lower income tax for most families. One of the few present law itemized deductions eliminated in the Siljander proposal is the deduction for medical expenses. This provides a good reason for families to keep their health insurance against catastrophic medical bills. The Treasury proposal's cap on health insurance might well result in a scaling back of the most generous health insurance plans either through increased copayments and deductibles or through elimination of certain types of non-hospitalization benefits.

Employer-sponsored dependent care assistance has only begun recently to receive attention from employers trying to tailor their benefit packages to employees' needs or to improve productivity and employee-retention rates. This exclusion of employer-provided dependent care assistance benefits higher-paid employees because the exclusion is likely to be worth more to them at their marginal rates than the 20 percent dependent care credit. It benefits lower-paid employees who might not have sufficient disposable income to purchase enough services to qualify for the full credit or to have enough tax liability to receive the non-refundable credit even if they did manage to pay for the dependent care. Bradley-Gephardt and Treasury repeal the exclusion of employer-provided dependent care assistance. By contrast, the Kemp-Kasten proposal which in many ways is structured to benefit the one-earner family with children, does not repeal the exclusion. It is conjectural as to whether under present law employer-provided dependent care will become a widespread employee benefit, but without the exclusion for such assistance it is quite unlikely to become a generally-available employee benefit.

CONCLUSION

As the foregoing analysis demonstrates, there is no tax alternative that stands out as clearly best for women or families. (Perhaps the Siljander proposal come closest to this mark because of the substantial tax cuts most taxpayers would receive under this alternative.) Because there are so many family configurations and financial patterns, it is impossible to define an "average" family against which to measure tax alternatives. Similarly, women not living in families have many different income and expenditure patterns, and generalizations cannot be made readily. The ten taxpayers used in this analysis, however, are illustrative of at least some of the major stereotypical categories. This analysis showed that several of these categories appear to be at risk. The two-earner family with high housing and tax expenses (No. 3), the two-earner family whose principal worker lost work for most of the year (No. 4), the single parent (No. 6), the single career woman (No. 7), and the retired couple with high medical expenses (No. 9) all had increased tax liability compared to present law under four out of five tax alternatives. Three categories of families appeared to be fairly well protected for the most part—the one-earner family of six, the poverty-level family of four, and the low-income widow. Even these conclusions, however, should be used only as a guide to further analysis. Because each of the examples hypothesized a variety of individualized financial circumstances, it would require further analysis to see whether these generalizations held up over a broader spectrum.

Considerations of equity between different marital statuses, family types and income levels are similarly muddy. However, it appears that the Bradley-Gephardt proposal substantially would protect under $40,000 two-earner families while the Treasury and Kemp-Kasten proposals seem to lean somewhat in the direction of the one-earner family. Items such as the dependent care credit and the two-earner deduction were enacted originally to alleviate perceived inequities under prior law. Their repeal and the introduction of new "reforms" such as an increased spousal IRA and an increased zero bracket for single household heads cannot be evaluated alone. They are all surrounded by other changes which can either magnify or minimize their impact. Thus, it is hard to assess the impact of these changes and, unfortunately, the conclusions to be drawn are not as clear cut as one would like.

APPENDIX 1

(1) "AVERAGE" FAMILY

Ann and Bill, both 32, both work outside the home, a typical pattern for married couples today, some 43 percent of whom rely exclusively on the earnings of the husband and wife. Their earnings are about average for married couples who both work.

They are buying their own home, probably more because they need a place to raise their two children than because of any tax considerations. Their property tax is about the average amount claimed by itemizers at their income level, although it is considerably lower than that paid by residents of many localities.

Their dependent care situation is atypical. They have placed their three-year-old daughter in a full-time daycare center which accounts for a large portion of their $2,800 outlay. Their eight-year-old son goes to a neighbor's home after school; the payments to the neighbor for this service are fairly low. Bill's company is truly innovative in that it decided to sponsor a summer day camp for school-age children of employees.

Bill receives a very large package of medical insurance which provides first-dollar coverage for all the family's medical and dental needs.

	1986	After 25 percent inflation
Income:		
Ann—wages	$12,000	$15,000
Bill—wages	23,000	28,750
Benefits:		
Medical insurance, including dental	2,600	3,250
Life insurance	115	144
Dependent care (free-summer day camp)	500	625
Interest received	230	288
Expenses:		
IRA contribution	2,150	2,688
Other savings or investments	300	375
FICA	2,503	3,347
State and local income tax	1,100	1,375
Property tax	800	1,000
Sales tax	325	406
Home mortgage interest (mean mtg. ded. for taxpayers at this income level)	2,750	3,438
Credit card and auto interest	1,000	1,250
Contributions	650	813
Dependent care	2,800	3,500

FAMILY NO. 1—ANN AND BILL—1986

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income						
Wages	$35,000	$35,000	$35,000	$35,000	$35,000	$35,000
Benefits:						
Medical insurance		2,600		500	2,600	
Life insurance		115		115		
Dependent care		500		500		
Interest	230	230	230	230	230	
Gross income	35,230	38,445	35,230	36,345	37,830	35,000
Adjustments:						
IRA contribution	(2,150)	(2,150)	(2,150)	(2,150)	(2,150)	
2-earner	(1,200					
20 percent empl. excl.			(7,000)			
Adjusted gross income	31,880	36,295	26,080	34,195	35,680	35,000
Deductions:						
Dependent care		3,300		3,300		
State/local taxes	1,100	1,100		550	1,100	
Real estate tax	800	800	800	400	800	
Sales tax	325			163	325	
Mortgage interest	2,750	2,750	2,750	2,750	2,750	
Consumer interest	1,000	230		1,000	1,000	
Charitable contribution	650	650	650		650	
Subtotal	6,625	[1] 4,880	4,200	8,163	6,625	
Zero-bracket amount	(3,710)	(6,000)	(3,300)	(3,800)		
Excess itemized deduction	2,915	3,950	900	4,363	6,625	
Personal exemptions	4,360	5,200	8,000	8,000	8,400	13,230
Taxable income	24,605	21,145	17,180	21,832	20,655	21,770
Tax	3,288	2,960	3,331	2,705	2,065	4,136
Credits (dependent care)	560					
Total tax	2,728	2,960	3,331	2,705	2,065	4,136
Tax/gross income (percent)	8.0	7.7	9.5	7.5	5.5	11.8
Nominal marginal rate (percent)	22	14	25	15	10	19

FAMILY NO. 1—ANN AND BILL—1986—Continued

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Change from present law:						
Dollars		+232	+603	−23	−663	+1,408
Percent		+8.5	+22	−1	−24	+52

[1] Excludes dependent care and charitable contribution.

FAMILY NO. 1—AFTER 25 PERCENT INFLATION

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income						
Wages	43,750	43,750	43,750	43,750	43,750	43,750
Benefits:						
Medical insurance		3,250		625	3,250	
Life insurance		144		144		
Dependent care		625		625		
Interest	288	288	288		288	
Gross income	44,038	48,057	44,038	45,144	47,288	43,750
Adjustments:						
IRA contribution	(2,688)	(2,688)	(2,688)	(2,688)	(2,688)	
2-earner	(1,500)					
20 percent empl. excl			(8,750)			
Adjusted gross income	39,850	45,369	32,600	42,456	44,600	43,750
Deductions:						
Dependent care		4,125		4,125		
State/local income tax	1,375	1,375			1,375	
Real estate tax	1,000	1,000	1,000		1,000	
Sales tax	406				406	
Mortgage interest	3,438	3,438	3,438	3,438	3,438	
Consumer interest	1,250	288		962	1,250	
Charitable contribution	813	813			813	
Subtotal	8,282	11,039	4,438	[1] 4,400	8,281	
Zero-bracket amount	(4,640)		(4,130)	(4,750)		
Excess itemized deduction	3,642	11,039	308	4,125	8,281	
Personal exemptions	5,450	5,200	10,000	10,000	10,500	16,537
Taxable income	30,758	29,130	22,292	28,331	25,819	27,213
Tax	4,111	4,688	4,359	3,537	2,581	5,170
Credits	700					
Total tax	3,411	4,688	4,350	3,537	2,581	5,170
Tax/gross income (percent)	7.7	9.8	9.9	7.8	5.5	11.8
Nominal marginal rate (percent)	22	14	24	15	10	19
Change from present law:						
Dollars		1,277	+948	+126	−830	−1,759
Percent		+37	+28	+4	−24	+52
Change from 1986:						
Dollars	+683	+1,571	+1,028	+832	+516	+1,034
Percent	+25	+50	+31	+31	+25	+25

[1] Excludes dependent care.

(2) "TRADITIONAL" LARGE FAMILY

Cathy, age 28, and Dave, age 29, are strongly committed to their choice to live by traditional values. They married young and are delighted to have had four children already, two daughters ages 8 and 2 and two sons ages 7 and 5. (There are 2.1 million families in the U.S. with this many children, who comprise only 3 percent of all families, 6 percent of all married couples and 1.4 percent of all households (1982 figures)).

Bill earns the median income for couples in which only the husband works outside the home—$426 per week or $22,000 on an annual basis. This is somewhat less than the median income in 1981 for families of 6 ($26,907), making it a struggle for them to buy their own home and to maintain it properly.

Cathy is busy at home and with the various activities of their church and community around which their and their children's lives are focused.

Their oldest daughter attends the school operated by their church; they hope to be able to afford to send their sons next year as well.

	1986	After 25 percent inflation
Income:		
Cathy	0	0
Dave:		
Wages	$23,000	$28,750
Medical and disability insurance (employer pays half)	1,100	1,375
Life insurance	48	60
Interest received	98	123
Expenses:		
IRS contribution	0	0
Other savings	150	188
Medical insurance	1,100	1,375
Other medical (checkups, copayments, medicine, etc.)	250	313
FICA	1,644	2,199
State and local income tax	652	815
Property tax	731	914
Sales tax	246	307
Home mortgage interest	2,500	3,125
Credit card and charge account interest	500	625
Contributions	350	438
School tuition	900	1,125

FAMILY NO. 2—CATHY AND DAVE—1986

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	23,000	23,000	23,000	23,000	23,000	23,000
Benefits:						
Medical and disability insurance		1,100			1,100	
Life insurance		48		48		
Interest	98	98	98	98	98	
Gross Income:	23,098	24,246	23,098	23,146	24,198	23,000
Adjustments:						
20 percent employee exclusive			(4,600)			
Adjusted gross income	23,098	24,246	18,498	23,146	24,198	23,000
Deductions:						
Medical	195			247		
State/local income taxes	652	652		326	652	
Real estate tax	731	731	731	366	731	
Sales tax	246			123	246	
Mortgage interest	2,500	2,500	2,500	2,500	2,500	
Consumer interest	500	98		500	500	
Charitable contribution	350	350	350		350	
Subtotal	5,174	4,331	[1] 3,321	4,062	4,979	0
Zero-bracket amount	(3,710)	(6,000)	(3,330)	(3,800)		
Excess itemized deduction	1,464	350	350	262	4,979	
Personal exemptions	6,540	7,200	12,000	12,000	12,600	17,010
Taxable income	15,094	10,696	6,148	10,884	6,619	5,990
Total tax	1,522	1,497	684	1,063	662	1,138
Tax/gross income (percent)	6.5	6.2	3.0	4.6	2.7	4.9
Nominal marginal rate (percent)	16	14	24	15	10	19
Change in present law:						
Dollars		−17	−838	−459	−852	−384
Percent			−55	−30	−44	−25

[1] excludes charitable deduction.

FAMILY NO. 2—AFTER 25 PERCENT INFLATION

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	28,750	28,750	28,750	28,750	28,750	28,750
Benefits:						
Medical and disability insurance		1,375			1,375	
Life insurance		60		60		
Interest	123	123	123		123	
Gross income	28,873	30,308	28,873	28,810	30,248	28,750
Adjustments:						
20 percent employee exclusive			(5,750)			
Adjusted gross income	28,873	30,308	23,173	28,810	30,248	28,750
Deductions:						
Medical	244			310		
State/local income taxes	815	815			815	
Real estate tax	914	914	914		914	
Sales tax	307				307	
Mortgage interest	3,125	3,125	3,125	3,125	3,125	

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FAMILY NO. 2—AFTER 25 PERCENT INFLATION—Continued

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Consumer interest	625	123		502	625	
Charitable contribution	438	438			438	
Subtotal	6,468	5,415	4,039	3,937	6,224	
Zero-bracket amount	(4,640)	(6,000)	(4,130))	(4,750)		
Excess itemized deductions	1,828	438			6,224	
Personal exemptions	8,175	7,200	15,000	15,000	15,750	21,262
Taxable income	18,870	16,670	8,123	13,810	8,274	7,488
Total tax	1,901	2,334	958	1,359	827	1,423
Tax/gross income (percent)	6.1	7.7	1.9	4.3	2.7	4.9
Nominal marginal rate (percent)	16	14	24	15	10	19
Change from present law:						
Dollars		+433	−1,329	−542	−1,064	−478
Percent		+23	−70	−29	−56	−25
Change from 1986:						
Dollars	+379	+837	+195	+296	+165	+285
Percent	+25	+56	+53	+28	+25	+25

(3) FAMILY WITH HIGH HOUSING AND TAX COSTS

Ellen and Frank and their two children have a financial profile identical to Ann and Bill's except for one major difference: they live in an area where housing costs and taxes are high. Even with the tax deductions in present law for mortgage interest and property tax, they consider themselves "house poor." Their state and local income taxes are also relatively high in comparison with other parts of the country.

	1986	After 25 percent inflation
Income:		
Ellen—wages	$12,000	$15,000
Frank—Wages	23,000	28,750
Benefits:		
Medical insurance	2,600	3,250
Life insurance	115	144
Dependent care	500	625
Interest	230	288
Expenses:		
IRA contribution	2,150	2,688
Other savings or investments	300	375
FICA	2,503	3,347
State and local income tax	1,500	1,875
Property tax	3,000	3,750
Sales tax	325	406
Home mortgage interest	4,000	5,000
Consumer interest	1,000	1,250
Contributions	650	813
Dependent care	2,800	3,500

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FAMILY NO. 3—ELLEN AND FRANK—1986

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	35,000	35,000	35,000	35,000	35,000	35,000
Benefits:						
Medical insurance		2,600		500	2,600	
Life insurance		115		115		
Dependent care		500		500		
Interest	230	230	230	230	230	
Gross income	35,230	38,445	35,230	36,345	37,830	35,000
Adjustments:						
IRA contribution	(2,150)	(2,150)	(2,150)	(2,150)	(2,150)	
2-earner	(1,200)					
20 percent empl. excl			(7,000)			
Adjusted gross income	31,880	36,295	26,080	34,195	35,680	35,000
Deductions:						
Dependent care		3,300		3,300		
State/local taxes	1,500	1,500		750	1,500	
Real estate tax	3,000	3,000	3,000	1,500	3,500	
Sales tax	325			163	325	
Mortgage interest	4,000	4,000	4,000	4,000	4,000	
Consumer interest	1,000	230		1,000	1,000	
Charitable contribution	650	650	650		650	
Subtotal	10,475	12,680	7,650	10,713	10,475	
Zero-bracket amount	(3,710)		(3,300)	(3,800)		
Excess itemized deduction	6.765	12,680	4,350	6,913	10,475	
Personal exemptions	4,360	5,200	8,000	8,000	8,400	13,230
Taxable income	20,755	18,415	13,780	19,282	16,805	21,770
Tax	2,493	2,578	2,503	2,322	1,680	4,163
Credits (dependent care)	560					
Total tax	1,933	2,578	2,503	2,322	1,680	4,163
Tax gross income (percent)	5.5	6.7	7.1	6.4	4.4	11.9
Nominal marginal rate (percent)	18	14	24	15	10	19
Change from present law:						
Dollars		+645	+570	+389	−253	+2,203
Percent		+33	+29	+20	−13	+115

FAMILY NO. 3—AFTER 25 PERCENT INFLATION

	Present law	Bradley-Gephardt	Kemp-Kastin	Treasury	Siljander	DeConcini
Income:						
Wages	43,750	43,750	43,750	43,750	43,750	43,750
Benefits:						
Medical insurance		3,250		625	3,250	
Life insurance		144		144		
Dependent care		625		625		
Interest	288	288	288		288	
Gross income	44,038	48,057	44,038	45,144	47,288	43,750
Adjustments:						
IRA contribution	(2,688)	(2,688)	(2,688)	(2,688)	(2,688)	
2–earner	(1,500)					
20 percent empl. excl			(8,750)			

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FAMILY NO. 3—AFTER 25 PERCENT INFLATION—Continued

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Adjusted gross income	39,850	45,369	32,600	42,456	44,600	43,750
Deductions:						
Dependent care		4,125		4,125		
State/local taxes	1,875	1,875			1,875	
Real estate tax	3,750	3,750	3,750		3,750	
Sales tax	406				406	
Mortgage interest	5,000	5,000	5,000	5,000	5,000	
Consumer interest	1,250	288		962	1,250	
Charitable contribution	813	813	813		813	
Subtotal	13,094	15,851	9,563	10,087	13,094	
Zero-bracket amount	(4,640)		(4,130)	(4,750)		
Excess itemized deduction	8,454	15,851	5,433	5,337	13,094	
Personal exemptions	5,450	5,200	10,000	10,000	10,500	16,538
Taxable income	25,946	24,318	17,167	27,119	21,006	27,212
Tax	3,114	4,014	3,129	3,355	2,100	5,170
Credits (dependent care)	700					
Total tax	2,414	4,014	3,129	3,355	2,100	5,170
Tax gross income	5.8	8.4	7.1	7.4	4.4	11.8
Nominal marginal rate (percent)	18	26	24	15	10	19
Change from present law:						
Dollars		+1,600	+715	+941	−314	+2,756
Percent		+66	+30	+39	−13	+114
Change from 1986:						
Dollars	+481	+1,437	+626	+1,033	+420	+1,007
Percent	+25	+56	+25	+44	+25	+25

(4) FAMILY EXPERIENCING PROLONGED UNEMPLOYMENT

Gwen and Hal have identical financial circumstances as Ann and Bill except that in March, the plant where Hal worked closed its doors. This gave their town a very high unemployment rate and only temporary jobs have been available since then.

Hal qualified for the maximum unemployment benefit ($175/week) but these benefits will be exhausted after 34 weeks—around Thanksgiving. Gwen arranged for low option medical insurance through her employer to replace Hal's lost coverage; however, she must pay $75/mo. for this insurance, which does not include dental care and which has high deductibles and copayments. Hal also lost his term life insurance and access to the company's summer day camp for school-age children.

Changes in the family's spending pattern, in addition to various household economies, included cutting back their daughter's out-of-home daycare to an average of 2 days a week beginning in June to give Hal a chance to job hunt; during the remaining three days he looks after her. They spent $1,000 of their savings and reduced their contributions to their IRA accounts. Housing and tax expenses remained the same.

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	1986	After 25 percent inflation
Income:		
Gwen:		
Wages	$12,000	$15,000
Medical benefits (50 percent employer share)	824	1,031
Hal—Wages (January-March)	5,750	7,187
Benefits:		
Medical benefits (January-March)	649	812
Life insurance (January-March)	14	18
Temporary & part-time jobs	1,200	1,500
Unemployment compensation	6,300	7,875
Interest on savings	150	188
Expenses:		
IRA contributions	500	625
Medical insurance payments (50 percent employee share)	825	1,031
Out-of-pocket medical, dental	500	625
FICA	1,355	1,812
State/local income tax	600	750
Property tax	800	1,000
Sales tax	240	300
Mortgage interest	2,750	3,437
Credit card interest	300	375
Contributions	340	425
Dependent care (January-March: $233/mo., Apr-Dec $25 wk.)	1,867	2,333

FAMILY NO. 4—GWEN AND HAL—1986

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	18,950	18,950	18,950	18,950	18,950	18,950
Benefits:						
Medical insurance		1,473		125	1,473	
Life insurance		14		14		
Unemployment compensation	3,102	6,300	6,300	6,300	3,027	6,300
Interest	150	150	150	150	150	
Gross income	22,202	26,887	25,400	25,539	23,600	25,250
Adjustments:						
IRA contribution	(500)	(500)	(500)	(500)	(500)	
2-earner	695					
20 percent empl. excl			(3,790)			
Adjusted gross income	21,007	26,387	21,110	25,039	23,100	25,250
Deductions:						
Dependent care		1,867		1,867		
Medical	274			79		
State/local income taxes	600	600		300	600	
Real estate tax	800	800	800	400	800	
Sales tax	240			120	240	
Mortgage interest	2,750	2,750	2,750	2,750	2,750	
Consumer interest	300	150		300	300	
Charitable contribution	340	340	340		340	
Subtotal	5,304	[1] 4,300	3,890	5,816	5,030	
Zero-bracket amount	(3,710)	(6,000)	(3,330)	(3,800)		
Excess itemized deduction	1,594	2,207	590	2,016	5,030	
Personal exemptions	4,360	5,700	8,000	8,000	8,400	13,230
Taxable income	15,053	12,980	12,520	15,023	9,670	12,020
Tax	1,515	1,817	2,212	1,683	967	2,284

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FAMILY NO. 4—GWEN AND HAL—1986—Continued

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Credits (dependent care)	448					
Total tax	1,067	1,817	2,212	1,683	967	2,284
Tax/gross income (percent)	4.8	7.6	8.7	6.6	4.0	9.0
Nominal marginal rate (percent)	16	14	24	15	10	19
Change from present law:						
Dollars		+750	+1,145	+618	−98	+1,219
Percent		+70	+107	+58	−9	+114

[1] Excludes dependent care and charitable contribution.

FAMILY NO. 4—AFTER 25 PERCENT INFLATION

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	23,687	23,687	23,687	23,687	23,687	23,687
Benefits:						
Medical insurance		1,843		156	1,843	
Life insurance		18		18		
Unemployment compensation	6,129	7,875	7,875	7,875	6,129	7,875
Interest	188	188	188		188	
Gross Income	30,004	33,611	31,750	31,736	31,847	31,562
Adjustments:						
IRA contribution	(625)	(625)	(625)	(625)	(625)	
2-earner	(868)					
20 percent empl. excl			(4,737)			
Adjusted gross income	28,511	32,986	26,388	31,111	31,222	31,562
Deductions:						
Dependent care		2,333		2,333		
Medical	230			70		
State/local income taxes	750	750			750	
Real estate tax	1,000	1,000	1,000		1,000	
Sales tax	300				300	
Mortgatge interest	3,437	3,437	3,437	3,437	3,437	
Consumer interest	375	188		187	375	
Charitable contribution	425	425			425	
Subtotal	6,517	[1] 5,375	4,437	[1] 3,624	6,284	
Zero-bracket amount	(4,640)	(6,000)	(4,130)	(4,750)		
Excess itemized deduction	1,877	2,758	307	2,333	6,284	
Personal exemptions	5,450	5,200	10,000	10,000	10,500	16,537
Taxable income	21,184	19,028	16,081	18,788	14,438	15,025
Tax	2,271	2,664	2,868	2,256	1,444	2,855
Credits (dependent care)	466					
Total tax	1,805	2,664	2,868	2,104	1,444	2,855
Tax/gross income (percent)	6.0	7.9	9.0	6.6	4.5	9.0
Nominal marginal rate (percent)	16	14	24	15	10	19
Change from present law:						
Dollars		+859	+1,063	+299	−391	+1,050
Percent		+48	+59	+17	−21	+58
Change from 1986:						
Dollars	+738	+847	+595	+421	+477	+578
Percent	+69	+47	+26	+40	+49	+25

[1] Excludes dependent care and charitable contribution.

[illegible]

(5) FAMILY BELOW POVERTY LEVEL

Irene, 40, and Jack, 42, have a below-poverty income despite the fact that both are working. Jack's $3.75/hr. job provides no benefits other than paid holidays and sick leave. Irene works one or two days a week to supplement their income and one of their two teenage daughters babysits occasionally to earn pocket money. The family qualifies for food stamps and received energy assistance to help with the expense of heating their apartment.

	1986	After 25 percent inflation
Income:		
Irene (no benefits)	$2,500	$3,125
Jack (no benefits except vacation)	7,800	9,750
Eldest daughter (babysitting)	300	375
Food stamps	1,500	[1] 1,875
Energy assistance	300	375
Interest	0	0
Expenses:		
IRA contribution	0	0
Medical insurance	0	0
Other medical expenses	350	438
State and local income taxes	70	88
FICA	736	985
Property tax	0	0
Sales tax	140	175
Mortgage interest	0	0
Consumer interest	30	38
Contributions	75	94

[1] Food stamps are indexed to food price increases rather than to the overall CPI and therefore may not increase precisely 25 percent during a period of 25 percent inflation.

FAMILY NO. 5—IRENE AND JACK—1986

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	10,300	10,300	10,300	10,300	10,300	10,300
Food stamps						
Energy assistance						
Gross income	10,300	10,300	10,300	10,300	10,300	10,300
Adjustments:						
2-earner	(250)					
20 percent empl. excl			(2,060)			
Adjusted gross income	10,050	10,300	8,240	10,300	10,300	10,300
Deductions:						
Medical						
State/local income taxes	70	70		35	70	
Sales tax	140			70	140	
Consumer interest	30			30	30	
Charitable contribution	75	75	75		75	
Subtotal	315	[1] 70	75	130	315	0
Zero-bracket amount	(3,710)	(6,000)	(3,300)	(3,800)		
Excess itemized deduction	75	75	75		315	

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FAMILY NO. 5—IRENE AND JACK—1986—Continued

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Personal exemptions	4,360	5,200	8,000	8,000	8,400	13,230
Taxable income	5,615	0	165	0	1,585	0
Tax	210	0	0	0	159	0
Credits (EITC)	116	116	376	153	0	0
Total tax	94	−116	−376	−153	159	0
Tax-gross income (percent)	+0.9	−1.1	−3.6	−1.5	+1.5	
Nominal marginal rate (percent)	23.2	12.2	15	12.2	10	
Change from present law:						
Dollars		−210	−470	−247	+65	+94
Percent		−223	−500	−263	+69	+100

[1] Excludes charitable contribution.

FAMILY NO. 5—AFTER 25 PERCENT INFLATION

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	12,875	12,875	12,875	12,875	12,875	12,875
Food stamps						
Energy assistance						
Gross income	12,875	12,875	12,875	12,875	12,875	12,875
Adjustments:						
2-earner	(312)					
20 percent empl. excl			(2,575)			
Adjusted gross income	12,563	12,875	10,300	12,875	12,875	12,875
Deductions:						
Medical						
State/local income taxes	88	88		44	88	
Sales tax	175			88	175	
Consumer interest	38			38	38	
Charitable contribution		94			94	
Subtotal	395	94		170	395	0
Zero-bracket amount	(4,640)	(6,000)	(4,130)	(4,750)		
Excess itemized deduction		94				
Personal exemptions	5,540	5,200	10,000	10,000	10,500	16,537
Taxable income	7,023	1,581	300	2,875	1,980	0
Tax	262	221	0	0	198	0
Credits (EITC)	0	0	538	191	0	0
Total tax	262	221	−538	−191	198	0
Tax-gross income (percent)	+2.0	+1.7	−4.2	−1.5	1.5	
Nominal marginal rate (percent)	11	14		12.2	10	
Change from present law:						
Dollars		−41	−800	−191	−64	−262
Percent		−16	−305	−173	−24	−100
Change from 1986:						
Dollars	+168	+337	−162	+38	+39	
Percent	+178	+290	−43	−25	+25	

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(6) MOTHER-ONLY FAMILY

Karen, age 26, is divorced and lives in an apartment with her six-year-old son. She earns about the median income for a single mother with one child, $240 a week or about $12,500 for year-round, full-time work. However, female-headed families experience a 17 percent unemployment rate. When Karen lost her job, she was able to collect unemployment compensation to tide her over until she became reemployed about two months later. During this time, her ex-husband made several child support payments.

Karen's budget allows for no extras. Since both of her jobs during the year were "temporary" positions, she did not receive health insurance. Therefore she considers herself very lucky that neither she nor her son had any serious illnesses during the year.

Now that her son is in school, Karen's daycare expenses consist of payments to a neighbor for after school care and the expense of a summer day camp operated by a local community service agency.

	1986	After 25 percent inflation
Income:		
Karen's wages	$11,500	$14,375
Interest	35	44
Unemployment compensation	1,000	1,250
Food stamps	225	[1] 281
Child support	500	625
Expenses:		
IRA contribution	0	0
Medical insurance	0	0
Medical expense	80	100
FICA	822	1,099
State/local income taxes	385	481
Sales tax	130	163
Credit card interest	40	50
Contributions	250	313
Dependent care	1,500	1,875
Savings	500	625

[1] Food stamps are indexed to food price increases rather than to the overall CPI and therefore may not increase precisely 25 percent during a period of 25 percent inflation.

FAMILY NO. 6—KAREN—1986

	Present law	Bradley-Gespardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	11,500	11,500	11,500	11,500	11,500	11,500
Interest	35	35	35	35	35	
Unemployment compensation	250	1,000	1,000	1,000	250	
Food stamps						
Child support						
Gross income	11,785	12,535	12,535	12,535	11,785	11,500
Adjustments:						
20 percent empl. excl			(2,300)			
Adjusted gross income	11,785	12,535	10,235	12,535	11,785	11,500
Deductions:						
Dependent care		1,500		1,500		
State/local income taxes	385	385		193	385	
Sales tax	130			65	130	

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FAMILY NO. 6—KAREN—1986—Continued

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Consumer interest	40			5	40	
Charitable contribution	250	250	250		250	
Subtotal	805	[1] 385	250	[1] 263	805	0
Zero-bracket amount	(2,510)	(3,000)	(3,200)	(3,500)		
Excess itemized deduction	250	1,750	250	1,500	805	
Personal exemptions	2,180	2,800	4,000	4,000	4,200	10,290
Taxable income	9,355	4,985	5,985	7,035	6,780	1,210
Tax	844	698	668	530	678	230
Credits:						
Dependent care	435					
EITC						
Total tax	409	698	668	530	678	230
Tax/gross income (percent)	3.5	5.5	5.3	4.2	5.8	2.0
Nominal marginal rate (percent)	17	14	24	15	10	19
Change from present law:						
Dollars		+289	+259	+121	+269	−179
Percent		+71	+63	+30	+65	−44

[1] Excludes dependent care.

FAMILY NO. 6—AFTER 25 PERCENT INFLATION

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	14,375	14,375	14,375	14,375	14,375	14,375
Interest	44	44	44		44	
Unemployment compensation	1,250	1,250	1,250	1,250	1,250	
Food stamps						
Child support						
Gross income	15,669	15,669	15,669	15,625	15,669	14,375
Adjustments:						
20 percent empl. excl			(2,875)			
Adjusted gross income	15,669	15,669	12,794	15,625	15,669	14,375
Deductions:						
Dependent care		1,875		1,875		
State/local income taxes	481	481			481	
Sales tax	163				163	
Consumer interest	50			6	50	
Charitable contribution		313			313	
Subtotal	694	[1] 481		[1] 6	1,007	0
Zero-bracket amount	(3,140)	(3,000)	(4,000)	(4,380)		
Excess itemized deduction		2,188		1,875	1,007	
Personal exemptions	2,725	2,800	5,000	5,000	5,250	12,862
Taxable income	12,944	7,681	7,794	8,750	9,412	1,513
Tax	1,263	1,075	911	655	941	287
Credits:						
Dependent care	506					
EITC						
Total tax	757	1,075	911	655	941	287

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FAMILY NO. 6—AFTER 25 PERCENT INFLATION—Continued

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Tax/gross income (percent)	4.8	6.9	5.8	4.2	6	2.0
Nominal marginal rate (percent)	17	14	24	15	10	19
Change in present law:						
Dollars		+318	+154	−102	+184	−470
Percent		+42	+20	−13	+24	−62
Change from 1986:						
Dollars	+348	+377	+243	+125	+263	
Percent	+85	+54	+36	+24	+39	+25

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[1] Excludes dependent care and charitable contribution.

(7) SINGLE WOMAN—LINDA

Linda, age 45, is a mid-level manager with a large corporation. Earning $35,000, she is well-paid compared with most single working women. (The 1982 median income for single women was $12,448. Only 7.4% had incomes over $35,000 and only 2% had incomes over $50,000.)

Because she has no plans to marry, Linda is concerned both with minimizing her tax payments and with building future financial security. Therefore, she takes full advantage of tax-favored retirement savings options and has taken a large mortgage on her condominium apartment. Furnishing this apartment, paying for a car, taking vacations and maintaining a "yuppie" lifestyle have consumed the rest of her disposable income, precluding other investments or tax shelters. She keeps a savings account for unexpected expenses.

	1986	After 25 percent inflation
Income:		
Wages	$35,000	$43,750
Benefits:		
Medical insurance	800	1,000
401(k) retirement savings	2,000	2,500
Employer match	1,000	1,250
Disability insurance	88	109
Group term life insurance	168	210
Interest	500	625
Expenses:		
IRA contribution	2,000	[1] 2,500
Other savings	1,200	1,500
FICA	2,717	3,634
State/local income taxes	1,200	1,500
Property tax	800	1,000
Sales tax	600	750
Mortgage interest	8,500	10,625
Consumer interest	1,500	1,875
Charitable contributions	600	750

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[1] Assumes that $500 goes to other savings or 401(k) plan if maximum contribution is not increased.

[redacted]

TAXPAYER NO. 7—LINDA—1986

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	35,000	35,000	35,000	35,000	35,000	35,000
Benefits:						
Medical insurance		800			800	
Disability insurance					88	
Group term life insurance		168		168		
Interest	500	500	500	500	500	
Gross income	35,500	36,468	35,500	35,668	36,388	35,000
Adjustments:						
401(k) retirement savings	(2,000)	(2,000)	(2,000)			
IRA contribution	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	
2-earner						
20 percent empl. excl			(7,000)			
Adjusted gross income	31,500	32,468	24,500	33,668	34,388	35,000
Deductions:						
State/local income taxes	1,200	1,200		600	1,200	
Real estate tax	800	800	800	400	800	
Sales tax	600			300	600	
Mortgage interest	8,500	8,500	8,500	8,500	8,500	
Consumer interest	1,500	500		1,500	1,500	
Charitable contribution	600	600	600		600	
Subtotal	13,200	11,600	9,900	11,300	13,200	
Zero-bracket amount	(2,510)		(2,600)	(2,800)		
Excess itemized deduction	10,690	11,600	7,300	8,500	13,200	
Personal exemptions	1,090	1,600	2,000	2,000	2,100	4,725
Taxable income	19,720	19,268	12,600	23,168	19,088	30,275
Total tax	2,955	3,534	3,024	3,442	1,908	5,752
Tax/gross income (percent)	8.3	9.7	9.0	9.7	5.2	16.7
Nominal marginal rate (percent)	23	26	24	25	10	19
Change in present law:						
Dollars		+579	+69	+487	−1,047	+2,797
Percent		+20	+2	+16	−35	+95

TAXPAYER NO. 7—AFTER 25 PERCENT INFLATION

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	43,750	43,750	43,750	43,750	43,750	43,750
Benefits:						
Medical insurance		1,000			1,000	
Disability insurance					110	
Life insurance		210		210		
Interest	625	625	625		625	
Gross income	44,375	45,585	44,375	43,960	45,485	43,750
Adjustments:						
401(k) retirement savings	(3,000)	(3,000)	(3,000)			
IRA contribution	(2,000)	(2,000)	(2,000)	(2,500)	(2,000)	
20 percent empl. excl			(8,750)			
Adjusted gross income	39,375	40,585	30,625	41,460	43,485	43,750

[redacted]

TAXPAYER NO. 7—AFTER 25 PERCENT INFLATION—Continued

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Deductions:						
State/local income taxes	1,500	1,500			1,500	
Real estate tax	1,000	1,000	1,000		1,000	
Sales tax	750				750	
Mortgage interest	10,625	10,625	10,625	10,625	10,625	
Consumer interest	1,875	625		1,250	1,875	
Charitable contribution	750	750	750		750	
Subtotal	16,500	14,500	12,375	11,875	16,500	
Zero-bracket amount	(3,140)		(2,060)	(3,500)		
Excess itemized deduction	13,360	14,500	10,315	8,375	16,500	
Personal exemptions	1,360	1,600	2,500	2,500	2,625	5,906
Taxable income	24,655	24,485	17,810	30,585	24,360	37,844
Total tax	3,694	5,322	3,780	4,709	2,436	7,190
Tax/gross income (percent)	8.3	11.7	8.5	10.7	5.4	16.5
Nominal marginal rate (percent)	23	14	24	25	10	19
Change in present law:						
Dollars		+1,628	+86	+1,015	−1,258	+3,496
Percent		+44	+2	+27	−34	+95
Change from 1986:						
Dollars	739	+1,788	+756	+1,267	+528	+1,438
Percent	25	+51	+25	+37	+28	+25

(8) PROFESSIONAL COUPLE

Mary, 32, and her husband, Nick, 35, are both successful young professionals in a major metropolitan area. They postponed having children until their careers are established. In the meanwhile, they are concentrating on building financial security and developing their professional capabilities.

They want to shelter their income from taxes, but their long hours and involvement with work prevent them from getting involved in complex ventures requiring a great deal of time or attention. However, they have taken full advantage of deferred compensation and savings plans offered by their employers as well as tax-favored savings for retirement through IRA and Keogh plans. They recently purchased a house large enough for their anticipated family needs in part because of the interest and tax deduction from this investment.

Mary is working toward a graduate degree in a field complementary to her specialty. Her tuition and expenses are paid for by her employer. Nick has organized a business which he hopes will develop into something that he can pursue on a full time basis.

Compared to most families, Mary and Nick must be considered quite well off. According to the Census Bureau the highest 5 percent of income for couples begins at about $67,000, so Mary and Nick's combined income of better than $87,000 places them 30 percent above this mark. For all joint tax returns filed by husbands and wives in 1982, only 3.2 showed incomes above $75,000. Despite their retirement savings and housing outlays, Mary and Nick have

[redacted]

some $37,000 left for personal expenses after paying their taxes (under current law).

	1986	After 25 percent inflation
Income:		
Mary—wages	$40,000	$50,000
Benefits:		
Medical insurance	2,600	3,250
Group term life insurance	60	75
Educational assistance	2,200	2,750
401(k) retirement savings:		
Wage reduction	4,000	5,000
Employer contribution	2,500	3,125
Nick—wages	35,000	43,750
Benefits: Group term life insurance	50	63
401(k) retirement savings: Wage reduction	2,500	3,125
Business profit	12,000	15,000
Interest	800	1,000
Expenses:		
IRA contribution	4,000	[1] 5,000
Keogh contribution	3,000	3,750
Other savings	1,000	1,250
FICA	5,964	7,941
State/local income taxes	2,700	3,375
Property tax	6,000	7,500
Sales tax	700	875
Mortgage interest—principal residence	18,000	22,500
Consumer interest	2,000	2,500
Charitable contributions	1,750	2,188

[1] Assuming that maximum contribution limit is increased; otherwise the $1,000 excess is put into 401(k) plan.

FAMILY NO. 8—MARY AND NICK—1986

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages (incl. 401(k))	75,000	75,000	75,000	75,000	75,000	75,000
Benefits:						
Medical insurance		2,600		500	2,600	
Life insurance		110		110		
Educational assistance	2,200	2,200	2,200	2,200	2,200	
(401(k) retirement savings)	(6,500)	(6,500)	(6,500)			
Business profit [1]	12,000	12,000	12,000	12,000	12,000	12,000
Interest	800	800	800	800	800	
Gross income	83,500	86,210	83,500	90,610	92,600	87,000
Adjustments:						
Keogh contribution	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	
IRA contribution	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	
2-earner	(3,000)					
20 percent empl. excl			[2] (15,420)			
Adjusted gross income	73,500	79,210	61,080	83,610	85,600	87,000
Deductions:						
State/local income taxes	2,700	2,700		1,350	2,700	
Real estate tax	6,000	6,000	6,000	3,000	6,000	
Sales tax	700			350	700	
Mortgage interest	18,000	18,000	18,000	18,000	18,000	
Consumer interest	2,000	800		2,000	2,000	
Charitable contribution	1,750	1,750	1,750	78	1,750	
Subtotal	31,150	29,250	25,750	24,778	31,150	

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FAMILY NO. 8—MARY AND NICK—1986—Continued

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Zero-bracket amount	(3,710)		(3,300)	(3,800)		
Excess itemized deduction	27,440	29,250	22,450	20,978	31,150	
Personal exemptions	2,180	3,200	4,000	4,000	4,200	9,450
Taxable income	43,880	46,760	34,630	58,632	50,250	77,550
Total tax	8,654	11,692	7,519	10,908	5,025	14,735
Tax/gross income (percent)	10.4	13.6	9.0	12.0	5.4	16.9
Nominal marginal rate (percent)	33	30	24	25	10	19
Change from present law:						
Dollars		+3,038	−1,135	+2,254	−3,629	+6,081
Percent		+35	−13	+26	−42	+70

[1] Assumes that profits were not affected by other features of the proposals.

[2] Assumes FICA base of $41,700.

FAMILY NO. 8—AFTER 25 PERCENT INFLATION

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages (incl. 401(k))	93,750	94,750	93,750	93,750	93,750	93,750
Benefits:						
Medical insurance		3,250		625	3,250	
Life insurance		138		138		
Educational assistance	2,750	2,750	2,750	2,760	2,750	
Interest	1,0000	1,000	1,000		1,000	
(401(k) retirement savings)	(9,125)	(9,125)	(9,125)			
Business profit	15,000	15,000	15,000	15,000	15,000	15,000
Gross income	103,375	106,763	103,375	112,273	115,750	108,750
Adjustments:						
Keogh contribution	(3,750)	(3,750)	(3,750)	(3,750)	(3,750)	
IRA contribution	(4,000)	(4,000)	(4,000)	(5,000)	(4,000)	
2-earner	(3,000)					
20 percent empl. excl.			[1] (19,185)			
Adjusted gross income	92,625	99,013	76,440	103,523	108,050	108,750
Deductions:						
State/local income taxes	3,375	3,375			3,375	
Real estate tax	7,500	7,500	7,500		7,500	
Sales tax	875				875	
Mortgage interest	22,500	22,500	22,500	22,500	22,500	
Consumer interest	2,500	1,000		1,500	2,500	
Charitable contribution	2,188	2,188	2,188	117	2,188	
Subtotal	38,938	36,563	32,188	24,117	38,938	
Zero-bracket amount	(4,640)		(4,130)	(4,750)		
Excess itemized deduction	34,298	36,563	28,058	19,367	38,938	
Personal exemptions	2,725	3,200	5,000	5,000	5,250	11,812
Taxable income	55,602	59,250	43,382	79,156	63,862	96,938
Total tax	11,063	16,577	9,420	15,102	6,386	18,418
Tax/gross income (percent)	10.75	13.1	9.1	13.5	5.5	16.9
Nominal marginal rate (percent)	33	30	24	25	10	19
Change from present law:						
Dollars		+5,514	−1,643	+4,039	−4,677	+7,355

[redacted]

FAMILY NO. 8—AFTER 25 PERCENT INFLATION—Continued

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Percent		+50	−15	+37	−42	+66
Change from 1986:						
Dollars	2,409	4,885	1,901	+4,194	+1,361	+3,683
Percent	28	42	+25	+38	+27	+25

[1] Assumes FICA base of $51,900.

(9) RECENTLY RETIRED COUPLE

Olive, 62, just retired, timing her plans to coincide with her husband's retirement. She receives a reduced social security benefit which is based on half her husband's check. She did not work for any of her employers long enough to qualify for a pension.

Paul, 65, also just retired. He receives the full social security maximum benefit plus a pension from his company. He has not begun drawing on his IRA account, and continues to earn some income for occasional work of the type he previously performed. Although in good general health, he had a major operation this year which was only partially paid for by Medicare and insurance. Both spouses' Part B premiums are deducted from their social security checks.

The couple lives in their own paid-for home. They have accumulated a substantial nest egg of savings and investments in stocks and bonds which they hope will provide them an adequate cushion to supplement their social security and pension in case of emergencies of unforeseen expenditures.

This is a fairly typical profile for couples of this age. According to a study by the Social Security Administration (Income of the Population 55 and Over, 1982—SSA Pub. No. 13-11871, March, 1984), 47% percent of couples aged 65–67 had income from earnings, 85% received social security, 35% received private pensions, 76% earned interest and 21% received dividends.

The median income for couples where the husband was in the 65–67 age bracket was $19,600 in 1982. This couple is about 10% above the median, after adjusting for inflation between 1982–86.

	1986	After 25 percent inflation
Income:		
Olive: Social Security	$3,300	[1] $4,125
Paul:		
Wages	5,000	6,250
Social Security	[1] 8,820	[1] 11,025
Pension	6,000	7,500
Interest	1,300	1,625
Dividends	1,400	1,750
Expenses:		
Medical insurance payments (including part B)	900	1,125
Out-of-pocket medical, dental	2,000	2,500
Medicines	500	625
FICA	358	478
State/local income tax	900	1,125
Property tax	800	1,000

[redacted]

	1986	After 25 percent inflation
Sales tax	225	281
Consumer interest	200	250
Contributions	500	625

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[1] Social security amounts projected based on 1985 actual benefits; social security benefits are indexed to wages rather than prices and therefore may not have risen by 25 percent during a period of 25 percent inflation.

FAMILY NO. 9—OLIVE AND PAUL—1986

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	5,000	5,000	5,000	5,000	5,000	5,000
Social Security						12,120
Pension	6,000	6,000	6,000	6,000	6,000	6,000
Dividends	1,200	1,400	1,400	1,400	1,400	
Interest	1,300	1,300	1,300	1,300	1,300	
Gross income	13,500	13,700	13,700	13,700	13,700	23,120
Adjustments:						
20 percent empl. excl			(1,000)			
Adjusted gross income	13,500	13,700	12,700	13,700	13,700	23,120
Deductions:						
Medical	2,725	2,030	2,184	2,715		
State/local income taxes	900	900		450	900	
Real estate tax	800	800	800	400	800	
Sales tax	225			113	225	
Consumer interest	200	200		200	200	
Charitable contribution	500	500	500	226	500	
Subtotal	5,350	[1] 3,930	[1] 2,984	4,104	2,625	
Zero-bracket amount	(3,710)	(6,000)	(3,300)	(3,800)		
Excess itemized deduction	1,640	500	500	304	2,625	
Personal exemptions	2,180	3,200	4,000	4,000	4,200	9,450
Additional exemption	1,090	1,000	2,000			
Taxable income	8,590	3,000	6,200	9,396	6,875	13,670
Total tax	569	420	696	839	688	2,597
Tax/gross income (percent)	4.2	3.0	2.9	6.1	5.0	11.2
Nominal marginal rate (percent)	14	14	24	15	10	19
Change from present law:						
Dollars		−149	+127	+269	+119	+2,027
Percent		−26	+22	+47	+21	+355

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[1] Excludes charitable contribution.

FAMILY NO. 9—AFTER 25 PERCENT INFLATION

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Wages	6,250	6,250	6,250	6,250	6,250	6,250
Social Security						15,150
Pension	7,500	7,500	7,500	7,500	7,500	7,500
Dividends	1,550	1,750	1,750	1,750	1,750	
Interest	1,625	1,625	1,625	756	1,625	
Gross income	16,925	17,125	17,125	16,256	17,125	28,900

[redacted]

FAMILY NO. 9—AFTER 25 PERCENT INFLATION—Continued

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Adjustments:						
20 percent empl. excl			(1,250)			
Adjusted gross income	16,925	17,125	15,875	16,256	17,125	28,900
Deductions:						
Medical	3,404	2,537	2,730	3,437		
State/local income taxes	1,125	1,125			1,125	
Real estate tax	1,000	1,000	1,000		1,000	
Sales tax	281				281	
Consumer interest	250	250			250	
Charitable contribution	625	625		300	625	
Subtotal	6,685	[1] 4,912	3,730	3,737	3,281	
Zero-bracket amount	(4,640)	(6,000)	(4,130)	(4,750)		
Excess itemized deduction	2,045	625			3,281	
Personal exemptions	2,720	3,200	5,000	5,000	5,250	11,812
Additional exemption	1,360	1,000	2,500			
Taxable income	10,800	6,300	8,375	11,256	8,594	17,088
Total tax	720	882	1,019	976	859	3,247
Tax/gross income (percent)	4.7	5.2	5.9	6.0	5.0	11.2
Nominal marginal rate (percent)	[illegible]	14	24	15	10	19
Change from present law:						
Dollars		+162	+299	+256	+139	+2,527
Percent		+23	+42	+36	+19	+351
Change from 1986:						
Dollars	151	+462	+323	+137	+171	+658
Percent	+27	+110	+46	+16	+25	+25

[1] Excludes charitable contribution.

(10) WIDOW

Ruth is an 82-year-old widow who lives primarily on her husband's social security benefit. Her social security benefit is slightly less than the median benefit for widows, based on 1982 data (updated for inflation).

Her husband's pension ceased when he died. Her only other income is interest from her savings account plus some series E government bonds purchased years ago by her husband. She occasionally receives gifts of needed items and clothes from her children who live in other cities and pays them extended visits once or twice a year.

Ruth lives in an apartment. Her health is stable but she must take medication and have frequent check-ups to monitor her heart condition, arthritis and diabetes.

	1986	After 25 percent inflation
Income:		
Social Security ($417/mo.)	[1] 5000	[1] 6,250
Interest from savings	500	625
Withdrawal from savings	750	938
Food stamps	200	[2] 250

[illegible]

	1986	After 25 percent inflation
Expenses:		
Medical insurance-part B premium	193	[3] 253
Out-of-pocket medical care	75	94
Medicines	600	750
Sales tax	90	114
State/local income tax		
Contributions	84	105

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[1] Social security benefits are indexed to wages rather than prices and therefore may not increase precisely 25 percent during a period of 25 percent inflation.

[2] Food stamps are indexed to food price increases rather than to the overall CPI and therefore may not increase precisely 25 percent during a period of 25 percent inflation.

[3] HHS projection based on current law; program is not indexed to the CPI.

TAXPAYER NO. 10—RUTH—1986

	Present law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Income:						
Social Security						5,000
Interest	500	500	500	500	500	
Adjusted gross income	500	500	500	500	500	5,000
Zero-bracket amount	(2,510)	(3,000)	(2,600)	(2,800)		
Personal exemptions	1,090	1,600	2,000	2,000	2,100	4,725
Additional exemptions	1,090	1,000	2,000			
Taxable income						275
Tax	0	0	0	0	0	52
Change from present law:						
Dollars						+52
Percent						

TAXPAYER NO. 10—AFTER 25 PERCENT INFLATION

	Present Law	Bradley-Gephardt	Kemp-Kasten	Treasury	Siljander	DeConcini
Social Security						6,250
Interest	625	625	625	344	625	
Adjusted gross income	625	625	625	344	625	6,250
Zero-bracket amount	(3,140)	(3,000)	(3,250)	(3,500)		
Personal exemptions	1,360	2,000	2,500	2,500	2,625	5,906
Additional exemptions	1,360	1,000	2,500			
Taxable income	0	0	0	0	0	344
Tax	0	0	0	0	0	65
Change from Present Law:						
Dollars						+65
Percent						

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APPENDIX 2

TAX COMPUTATION TABLES FOR TAX ALTERNATIVES

I. Present Law

A. Joint returns—1986:

Taxable income:	Tax is:
Under $3,710	0.
$3,710 to $6,000	11 percent of excess over $3,710.
$6,000 to $8,290	$252 plus 12 percent of excess over $6,000.
$8,290 to $12,990	$527 plus 14 percent of excess over $8,290.
$12,990 to $17,460	$1,185 plus 16 percent of excess over $12,990.
$17,460 to $22,040	$1,900 plus 18 percent of excess over $17,460.
$22,040 to $26,850	$2,724 plus 22 percent of excess over $22,040.
$26,850 to $32,630	$3,786 plus 25 percent of excess over $26,850.
$32,630 to $38,410	$5,231 plus 28 percent of excess over $32,630.
$38,410 to $49,980	$6,849 plus 33 percent of excess over $38,410.
$49,980 to $65,480	$10,666 plus 38 percent of excess over $49,980.
$65,480 to $93,420	$16,556 plus 42 percent of excess over $65,480.
$93,420 to $119,390	$28,290 plus 45 percent of excess over $93,420.
$119,390 to $177,230	$39,976 plus 49 percent of excess over $119,390.
$177,230 or more	$68,317 plus 50 percent of excess over $177,230.
After 25 percent inflation:	
Under $4,640	0.
$4,640 to $7,500	11 percent of excess over $4,640.
$7,500 to $10,360	$314 plus 12 percent of excess over $7,500.
$10,360 to $16,240	$658 plus 14 percent of excess over $10,360.
$16,240 to $21,830	$1,480 plus 16 percent of excess over $16,240.
$21,830 to $27,550	$2,373 plus 18 percent of excess over $21,830.
$27,550 to $33,500	$3,405 plus 22 percent of excess over $27,550.
$33,500 to $40,790	$4,731 plus 25 percent of excess over $33,500.
$40,790 to $48,010	$6,537 plus 28 percent of excess over $40,790.
$48,010 to $62,480	$8,560 plus 33 percent of excess over $48,010.
$62,480 to $81,850	$13,333 plus 38 percent of excess over $62,480.
$81,850 to $116,780	$20,695 plus 42 percent of excess over $81,850.
$116,780 to $149,240	$35,363 plus 45 percent of excess over $116,780.
$149,240 to $221,540	$49,970 plus 49 percent of excess over $149,240.
$221,540 or more	$85,396 plus 50 percent of excess over $221,540.

B. Head of household returns—1986:

Taxable income:	Tax is:
Under $2,510	0.
$2,510 to $4,800	11 percent of excess over $2,510.
$4,800 to $7,090	$252 plus 12 percent of excess over $4,800.
$7,090 to $9,490	$527 plus 14 percent of excess over $7,090.
$9,490 to $12,880	$863 plus 17 percent of excess over $9,490.
$12,880 to $16,370	$1,439 plus 18 percent of excess over $12,880.
$16,370 to $19,860	$2,067 plus 20 percent of excess over $16,370.
$19,860 to $25,650	$2,765 plus 24 percent of excess over $19,860.
$25,650 to $31,430	$4,155 plus 28 percent of excess over $25,650.
$31,430 to $37,210	$5,857 plus 32 percent of excess over $21,430.
$37,210 to $48,780	$7,706 plus 35 percent of excess over $37,210.
$48,780 to $66,130	$11,756 plus 42 percent of excess over $48,780.
$66,130 to $89,270	$19,043 plus 45 percent of excess over $66,130.
$89,270 to $118,190	$29,456 plus 48 percent of excess over $89,270.
$118,190 or more	$43,338 plus 50 percent of excess over $118,190.
After 25 percent inflation:	
Under $3,140	0.
$3,140 to $6,000	11 percent of excess over $3,140.
$6,000 to $8,860	$315 plus 12 percent of excess over $6,000.
$8,860 to $11,860	$659 plus 14 percent of excess over $8,860.
$11,860 to $16,100	$1,079 plus 17 percent of excess over $11,860.
$16,100 to $20,460	$1,799 plus 18 percent of excess over $16,100.
$20,460 to $24,830	$2,580 plus 20 percent of excess over $20,460.
$24,830 to $32,060	$3,456 plus 24 percent of excess over $24,830.
$32,060 to $39,290	$5,194 plus 28 percent of excess over $32,060.
$39,290 to $46,890	$7,321 plus 32 percent of excess over $39,290.

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TAX COMPUTATION TABLES FOR TAX ALTERNATIVES—Continued

$46,890 to $60,980	$9,633 plus 35 percent of excess over $46,890.
$60,980 to $82,660	$14,695 plus 42 percent of excess over $60,980.
$82,660 to $111,590	$23,804 plus 45 percent of excess over $82,660.
$111,590 to $147,740	$36,820 plus 48 percent of excess over $111,590.
$147,740 or more	$54,173 plus 50 percent of excess over $147,740.

C. Single returns—1986:

Taxable income:	Tax is:
Under $2,510	0.
$2,510 to $3,710	11 percent of excess over $2,510.
$3,710 to $4,800	$132 plus 12 percent of excess over $3,710.
$4,800 to $7,090	$262 plus 14 percent of excess over $4,800.
$7,090 to $9,280	$583 plus 15 percent of excess over $7,090.
$9,280 to $11,790	$912 plus 16 percent of excess over $9,280.
$11,790 to $14,080	$1,314 plus 18 percent of excess over $11,790.
$14,080 to $16,370	$1,726 plus 20 percent of excess over $14,080.
$16,370 to $19,860	$2,184 plus 23 percent of excess over $16,370.
$19,860 to $25,650	$2,986 plus 26 percent of excess over $19,860.
$25,650 to $31,430	$4,492 plus 30 percent of excess over $25,650.
$31,430 to $37,210	$6,228 plus 34 percent of excess over $31,430.
$37,210 to $45,290	$8,193 plus 38 percent of excess over $37,210.
$45,290 to $60,350	$11,263 plus 42 percent of excess over $45,290.
$60,350 to $89,270	$17,588 plus 48 percent of excess over $60,350.
$89,270 or more	$31,469 plus 50 percent of excess over $89,270.
After 25 percent inflation:	
Under $3,140	0.
$3,140 to $4,640	11 percent of excess over $3,140.
$4,640 to $6,000	$165 plus 12 percent of excess over $4,640.
$6,000 to $8,860	$328 plus 14 percent of excess over $6,000.
$8,860 to $11,600	$729 plus 15 percent of excess over $8,860.
$11,600 to $14,740	$1,140 plus 16 percent of excess over $11,600.
$14,740 to $17,600	$1,642 plus 18 percent of excess over $14,740.
$17,600 to $20,460	$2,157 plus 20 percent of excess over $17,600.
$20,460 to $24,830	$2,730 plus 23 percent of excess over $20,460.
$24,830 to $32,060	$3,733 plus 26 percent of excess over $24,830.
$32,060 to $39,290	$5,615 plus 30 percent of excess over $32,060.
$39,290 to $46,510	$7,783 plus 34 percent of excess over $39,290.
$46,510 to $56,610	$10,240 plus 38 percent of excess over $46,510.
$56,610 to $75,440	$14,079 plus 42 percent of excess over $56,610.
$75,440 to $111,590	$21,985 plus 48 percent of excess over $75,440.
$111,590 or more	$39,336 plus 50 percent of excess over $111,590.

2. Bradley-Gephardt

Basic tax on taxable income: 14 percent.

Surtax on AGI less net interest expense up to amount of interest income.

Joint: 12 percent on $40,000 to $65,000; 16 percent on $65,000 and over.

Head of Household: 12 percent on $25,000 to $37,500; 16 percent on $37,500 and over.

Single: 12 percent on $25,000 to $37,500; 16 percent on $37,500 and over.

3. Treasury

A. Joint returns—1986:

Taxable income:	Tax is:
Less than $3.800	0.
$3,800 to $31,800	15 percent of excess over $3,800.
$31,800 to $63,000	$4,200 plus 25 percent of excess over $31,800.
$63,800 and over	$12,200 plus 35 percent of excess over $63,800.
After 25 percent inflation:	
Less than $4,750	$0.
$4,750 to $39,750	15 percent of excess over $4,750.
$39,750 to $79,750	$5,250 plus 25 percent of excess over $39,750.
$79,750 and over	$15,250 plus 35 percent of excess over $79,750.

B. Head of household returns—1986:

Taxable income:	
Less than $3,500	0.
$3,500 to $25,000	15 percent of excess over $3,500.
$25,000 to $48,000	$3,225 plus 25 percent of excess over $25,000.

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TAX COMPUTATION TABLES FOR TAX ALTERNATIVES—Continued

$48,000 and over	$8,975 plus 35 percent of excess over $48,000.
After 25 percent inflation:	
Less than $4,380	0.
$4,380 to $31,250	$15 percent of excess over $4,380.
$31,250 to $60,000	$4,031 plus 25 percent of excess over $31,250.
$60,000 and over	$11,219 plus 35 percent of excess over $60,000.
C. Single returns—1986:	
Taxable income:	Tax is:
Less than $2,800	0.
$2,800 to $19,300	15 percent of excess over $2,800.
$19,300 to $38,100	$2,475 plus 25 percent of excess over $19,300.
$38,100 and over	$7,175 plus 35 percent of excess over $38,100.
After 25 percent inflation:	
Less than $3,500	0.
$3,500 to $24,125	15 percent of excess over $3,500.
$24,125 to $47,625	$3,094 plus 25 percent of excess over $24,125.
$47,625 and over	$8,969 plus 35 percent of excess over $47,625.

4. FICA

1986:	
Tax rate	7.15
Base	$41,700
1990:	
Tax rate	7.65
Base	$51,900

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FINANCIAL HELP FOR VULNERABLE FAMILIES: THE INCOME TRANSFER MENU

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The United States has been concentrating on cutbacks rather than on basic welfare reform in recent years. The Congress is currently exploring tax simplification. In short, this is not the time for comprehensive designs and specific income maintenance program proposals. However, the problems and the needs remain: persistent, indeed increasing poverty; long-term unemployment after exhaustion of unemployment benefits; single-parent families with no sources of support and few job skills; low-earner large families; homeless and penniless victims of emergency and catastrophe; youth who leave school without job skills or work prospects.

The lack of current legislative action, in short, does not justify forgetting the issue. What follows begins with the premise that this may be a time to add to the clarity of the debate and to "stockpile" some possibilities. As long as there is societal change there can be no long-term freeze of social policy.

BACKGROUND

More than fifteen years ago, what was to become a longer series of efforts to enact welfare reform under such banners as "a guaranteed income" or a "negative income tax" began with recommendations from President Lyndon Johnson's Heineman Commission (1969). The family assistance plan (FAP) of the Nixon administration was defeated three years later after a long fight and a complex debate. Modified versions of the plan were also turned back in 1972, but they did provide the design for Supplemental Security Income (SSI), a program unifying and federalizing public assistance for the aged, blind, and disabled. President Carter offered his two-track Better Jobs and Income program in 1977, distinguished those expected to work from those not considered employable, and combining administrative reform and simplification with some elements of an income guarantee and work requirements. After a long effort, this proposed reform, too, lost in 1980.

Over this time, several lessons have emerged: (a) the durability of many "welfare" principles which are traceable to Elizabethan poor law and early 19th century reform debates; (b) the difficulty of reconciling conservative and liberal perspectives on which vulnerable families should be aided—and how; and (c) the need to think of both tax and income maintenance strategies as interrelated in designing a realistic program. (Here we employ the term "income transfers" as the label which subsumes the variety of non-market

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devices whereby income is made available to individuals or families.)

Some brief historical background may be helpful.

As societies discovered economic need too extensive to be met by family and neighbors, church, or private charity, they invented "poor law", the precursor of modern public (social) assistance. This early and subsequent formalization of the public role was inevitable, given scale, costs, the need to settle the question of who pays, and the need to establish that there would be public accountability, administrative structures, and provision for meeting costs. But from the sixteenth century to last summer's AFDC amendments, the level and form of help have been sensitive to the possibility or likelihood that generous and easily obtained aid might create work disincentives. The "morally corrupt" might become malingerers and "exploit" their generous fellow men. The resulting policy and program strategies are familiar: demeaning means tests, low grant levels which are not competitive with minimum wage rates, preference for indoor relief (workhouses and almshouses) over relief while at home, loss of political rights, contracting-out of the labor of adult applicants and indenture of their children, preference for in kind over cash grants. The responsibility and financing remained local as well, since this continued the tradition of family and primary group responsibility, allowed neighbors or local officials opportunity to inhibit malingering and fraud, assured access to private help first if available, and resulted in levels of assistance attuned to local costs and labor markets. Moreover, local administrators retained considerable discretion in evaluating need and possible malingering; only the "worthy" could expect help. Those who were not of the community could be sent elsewhere.

In the United States, the most primitive and demeaning of these policies initially were modified in the late nineteenth century and changed substantially after the Great Depression and the enactment of the Social Security Act. Although the differentiation between the "deserving" and the "undeserving" poor was an old one, the "deserving", who were treated less punitively, were at first only those whose need might be ascribed to "Acts of God" (the physicially handicapped, the very old or infirm, perhaps the widows and young children of respected citizens who had died in accidents or from sudden illness). The Depression consolidated the notion that Acts of God (or of individually unavoidable social causation) could take the form of crop failure, fire, illness, and economic catastrophe which left people without income no matter how hardworking and motivated they were and had been. Means tests eventually were to become more objective; contracting out of the labor of recipients was to end and workfare to be forbidden; children no longer were specifically placed in foster care because their parents were poor; cash payments were guaranteed. Political rights, especially the right to vote, could no longer be forfeit as the result of public aid, a practice prevalent from colonial times but effectively gone since the early part of the century in most places. The courts and legislation eliminated various rules about settlement (residence) and the worst of the invasions of privacy and arbitrary discretion. There was to be "statewideness" in welfare administration under the 1935 law and an assistance staff hired through civil service procedures. Serious efforts were to be made to help people find work or receive needed training.

Nonetheless, the core historical characteristics of public assistance were to remain: an income and assets test which was stringent, a low grant level, and constant alertness to the work-welfare tie, so that disincentives would be avoided. While now there would be federal sharing of costs, the local contribution remained and the state set the standard of need for the means test. What is more, while discrimination was prohibited (and, later, the courts protected against infringement of liberties and rights simply because one was in receipt of aid), the state was not required to enact a particular grant level or meet any adequacy standard. The state legislatures still determined budgets. The result was and is the great variations in assistance levels in the AFDC (Aid to Families With Dependent Children) program, variations so great that some state grants were and are mere gestures, rescued only by the addition of a standardized food stamp program entitlement. Furthermore, in contrast to the practice in most countries, the U.S. public assistance programs were not designed to cover the intact household with two parents. This was not considered a "deserving" category without suspicion. Finally, in 1961, states were permitted to extend AFDC eligibility to children in intact families if their father were unemployed. Only half the states have taken advantage of this option and have done so under rules that have limited eligibility totals severely.

By contrast, as public consciousness and the political system absorbed the lessons of modern industrial society, and as democratization spread through the industrial world, a new program—indeed a new social invention—known as social security or social insurance began to protect those whose needs were predictable and obviously not attributable to moral failure or personal willfulness. Soon there were to be seen almost everywhere in industrialized countries programs of workmen's compensation (to deal with work injury), unemployment insurance, old age and survivors insurance, and disability insurance.[1] (Sickness benefits, while widespread, were not developed in the United States system). Here the individual rights were clear. Federal law, in the instance of social security (not workmen's compensation or the state-implemented unemployment insurance), set eligibility conditions and specific benefit formulas for the entire country. It was possible objectively to compute an individual's entitlements. The courts were available to adjudicate alleged violations.

Public assistance thus has become less punitive and less discriminatory by the 1960s and it even became more generous well into the 1970s. But social insurance, contributory in the United States, was a firm right.[2] Legislatures and courts made the assistance status less onerous in the 1970s, but social insurance was indexed, as was SSI, Supplemental Security Income, social assistance for the aged, blind, and disabled, which was enacted in 1972 and which now occupies a spot between assistance and insurance, since its guarantees are legislatively specific and justifiable, an income guarantee with a modest, specified assets test.

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[1] During the past decade most advanced industrial societies have had some difficulty with disability insurance because case totals have grown, costs become substantial, and functional disability is more difficult to objectify. This subject cannot be pursued here, however.

[2] I use social insurance to cover pension, disability, and unemployment insurance programs even though the popular term is social security. Internationally, and in the U.S. law, assistance and service programs as well as medical coverage are included in social security laws.

Why the ongoing problem, then? First, social insurance in the United States does not cover all contingencies and may provide a low benefit for those who work at the low-pay irregular jobs. It does not cover those not in the labor force, except perhaps as dependents. Second, unemployment insurance benefits are low and of limited duration. Third, father-headed, two-parent households are mostly ineligible for AFDC and, in any case, AFDC benefits, even when combined with food stamps, are very low in much of the country. Fourth, a miltiplicity of means-tested benefits, often with inconsistent eligibility levels (AFDC, Medicaid, food stamps, public housing) results in a very steep income decline if work brings in income above the eligibility level(s), i.e., there is a high "implicit tax rate." Finally, there are youths and single adults who find no work or are not qualified for available work, and who are ineligible for any aid. For many the only option may be local (general) assistance in those selected jurisdictions which offer it. Such assistance (home relief) does not involve any federal participation.

In short, many needs remain but the historic inhibitions remain as well: a balancing of adequacy versus work incentive, federal guarantees of at least a minimal standard of living and of standardized administration versus local variations and responsibility, providing "welfare" versus providing work, providing sufficient assistance to maintain a community standard versus restraining costs. To these dilemmas the historical record has added another: universal versus income or means-tested programs; that is, should the welfare versus social insurance differentiation, which perforce plays upon stigma and leaves one group permanently disadvantaged, be continued?

Finally, the experience of the 1960s and 1970s renewed another historical dichotomy: the choices between cash, on the one hand, and commodities and services ("kind") on the other. Concern with hunger in the 1960s revived food distribution, first through a commodities program and then through the Food Stamp program. The Food Stamp program began with a 1961 pilot, was formalized in 1964, was improved and indexed in 1971, expanded in 1973, and took its present form in 1977. The Congress that rejected the Nixon FAP proposals authorized the new, basic income guarantee at a cost no smaller than FAP estimates (perhaps because the urban poverty lobby and agricultural interests are a more powerful coalition than the one assembled for welfare reform).

Of course, there was another in kind program, namely the public housing initiatives, some of them targeted at the poor, which had begun during the New Deal. Medicaid, far more important and costly, was passed in 1965, building on earlier welfare-linked medical care programs. A very small low-income Home Energy Assitance program began in 1981, has changed at least twice, and varies by state.

In any case, the repertoire in the United States for aiding the vulnerable now includes the in-kind option, a return to the precash welfare patterns of earlier eras. These patterns were never quite given up, although for a time in the 1930s and 1940s cash was considered more dignified and effective then turkeys and Christmas baskets and more likely to encourage normalcy. On the other hand, some Congressional coalitions prefer in kind benefits. There also are observers who are not sure that the poor use money reliably and would rather target food, shelter, and medical care directly at them and their children.

Various tax devices also are part of the repertoire; however, it has been only during the past decade that they have been appreciated as such by most debate participants and policy makers.

The campaigns for a guaranteed income and a negative income tax may have failed in the intended format but we should not forget the food stamp development and the enactment of SSI. Moreover these campaigns did make policy makers and the public aware of a possible connection between social insurance, public assistance, and tax programs. By the 1970s this was a familiar association, even as social security experts in the international literature had begun to write about the need to integrate social security, assistance, and tax systems more systematically. A number of things had become apparent:

> A tax return is an income test of sorts and, at least in theory, just as an income above a certain level can be the basis for taxation, an income below a certain level can comprise a deficit to be made up, perhaps in part, by the public treasury;
>
> Public policy already was being used to help families through personal exemptions in the income tax system for taxpayers and their children and extra exemptions for the aged and the blind;
>
> Payroll taxes were being used as the vehicle for contributions by employers and employees to the costs of Old Age, Survivors, Disability and Health Insurance (OASDHI) and unemployment insurance, and such contributions determined subsequent eligibility for benefits;
>
> Decisions to tax or not to tax employer-provided health and pension benefits, or public social security benefits, including unemployment insurance, both helped shape the worth of such benefits and created incentives or disincentives to offer them;
>
> Tax policy could make contributions to private charities less or more costly to individual taxpayers and to corporations; and
>
> Tax credits and tax deductions could help people pay for their mortgages, local taxes, health and prescription drug costs and, most recently, the day care and other dependent care costs of working adults. In a sense, these, too, should be regarded as federal expenditures.

In short, the repertoire of income transfers which may be drawn upon currently by public policy, whether to assist the vulnerable or any citizens, consists of strategies identified by the shorthand terms public assistance, social insurance, tax policy and service-benefits in kind. In some instances, the programs may belong to more than one of these families of methods.

LESSONS FROM OTHER COUNTRIES

In the late 1970s, the Cross National Studies program at Columbia University was funded by the Family Assistance Research Program of the Social Security Administration to conduct comparative research designed to shed light on American income maintenance programs and their future possibilities. Teams worked in the U.S. and seven other advanced industrial societies (Canada, England, France, Germany, Sweden, Israel, Australia). Two volumes and a series of policy-focused articles were published in 1983 and 1984. Several other papers are in press. (All of this work is co-authored with Sheila B. Kamerman). I offer some findings relevant to the present discussion without attempting a full overview.

Working with research teams in all these countries, we identified a group of families deemed vulnerable and thus the objects of income transfer policies. Vulnerable families, who are described in greater detail in Chart A, were defined as including:

The long- and short-term unemployed, some of whom were in work-training programs and some of whom were not;

Single mothers raising children; some of the mothers were in the labor force and some not; some were receiving child support from the child's father and others were not; and

Large, two-parent families with one average-wage earner.

There vulnerable families were contrasted with somewhat better situated families (also described in more detail in Chart A). These included:

Families with two earners;

One- and two-earner families earning multiples of the average wage in a particular country; and

Childless families, one of which had an unemployed member and the other a mother on leave for childbirth.

We also compared the vulnerable families and the so-called "traditional" two-parent, two-child family with a sole earner of average wages. However, we found that its situation was in fact more similar to the vulnerable than to the contrast families; in many countries it was so regarded and the object of specific supportive mesures.[3]

Our analytic method is elaborated elsewhere, but the following is essential to what follows: the research teams computed each family's income maintenance entitlements for calendar year 1979, subtracted compulsory social insurance contributions, and in the light of earnings and transfer income, determined each family's local and national income tax obligations (or entitlements under tax credit programs). Each family's net (after-tax) income for the year was determined. Then, to permit cross-national (or, in the United States, inter-state) comparisons, each family's net income was expressed as a percentage of the wage of the average production worker in its country for the same year. The ratios were also expressed on a per capita basis (since the families had different numbers of members), utilizing several alternative equivalency measures, in view of the fact that families enjoy some economies of scale and that adults and children have different consumption needs.

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[3] Not included in the study were several categories of the economically vulnerable aged.

The data collected enabled us to compare the "vulnerable" and the "contrast" families within each country, so as to identify the types of families treated most "generously" (i.e., those families with the highest family and per capita income, as compared with the net income of the country's average production worker). We also were able to compare different countries with regard to each family type (determining which countries were, relative to their own standards, generous to each specific type). Finally, comparisons of vulnerable families with contrast families as a group and, then, within countries could be used to shed light on the essentials of income transfer policy overall.

Given the sponsorship and locus of the research, the United States analysis was somewhat more elaborate. To take account of different state benefit levels and state/local tax variations, the general analysis included two states. New York was chosen as one of the highest benefit states in the nation and Pennsylvania as somewhere between a quarter and a third way down the benefit-level distribution, depending upon the index chosen. Since it was learned early that (relative to United States standards) Pennsylvania's benefits to vulnerable families were less adequate than were benefits in any of the other countries, relative to their own average wages, we did not add states which ranked even lower to the international comparisons. However, to understand the effects of specific income maintenance programs and what occurred if one attended to local salaries and taxes, a supplementary analysis was made for Tennessee and Alabama, which are near the bottom of the U.S. in grant levels.

The analysis of ranks and contrasts completed, we could examine the specific programs and policies through which the results were achieved. We could look specifically at social insurance, public assistance and tax programs and at their differential impacts.

Available time and space permits us to present in summary form findings of particular interest to the present discussion.[4]

COUNTRIES AND FAMILIES

The reader may find it helpful at this point to consider two charts and four tables which provide orientation to the results: Chart A, which identifies the families as reported in the tables; Table 1, which compares the "generosity scores" (the family's end-of-the-year income as a percentage of the net average production worker's wage for the particular country) of fifteen families in eight countries; Table 2, which uses these data to create rankings for each family type by country; Table 3, which ranks target (vulnerable) families by country in accord with a consolidated score, and also does as much for the contrast families; Table 4, which looks in more detail at the role of social assistance in the income of vulnerable families in all countries; Chart B, which summarizes the programs available to these families in the different countries.

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[4] The question arises as to whether a new analysis would show results very different from those obtained with 1979 date (the analysis took several years). While several of the countries have made changes, such changes have been at the margins, not in program cores. At the same time the United States has curbed some unemployment benefits and eligibility levels for AFDC and food stamps. While not certain, we would expect a new analysis would repeat our central findings.

While these tables only illustrate the types of data available, they will clarify for the reader the pattern of analysis behind some of the relevant conclusions briefly summarized herein:

1. The differences in generosity rankings among countries (Table 3) are not random. The three countries which have set out with explicit policies to provide specific income underpinnings to vulnerable families with children clearly have accomplished this. Sweden, France, and the Federal Republic of Germany (West Germany), each with its own rationale, have targeted the vulnerable and have accomplished their objectives. They lead in generosity. The countries appear in the tables in order of per capita income (per capita GNP); while this factor is not unimportant, the generosity scores show that policy at times shifts priorities. The consistency in status of the vulnerable and contrast families in some places (France, for example) and the very different rankings in others (Sweden) reflect very different attitudes towards redistribution in support of family benefits.

These ranking differences mean real consumption to real families. For example, Table 1 should be interpreted as follows: a single mother, not in the labor force and rearing two young children (Family 1a) receives through various transfer payments in the course of the year 93.8 percent of the net after-tax average production worker's wage in Sweden, 78.6 percent in France, and 67.3 percent in Germany. The same type of family receives half or slightly over half that level of the Swedish level of support in the four countries perpetuating some of the earlier poor law traditions: Canada, the United Kingdom, Australia, and Israel. New York is also in this group. Pennsylvania follows at 44 percent. Alabama and Tennessee, not shown in the table, have scores of 31.4 and 33.1.

About two-thirds to three-quarters of American states are less generous, relatively, to this family type than all countries in the research although the United States is one of the wealthiest countries in the group.

2. Income maintenance generosity raises the consumption floor for vulnerable families significantly and modifies the degree of difference between the resources of vulnerable and contrast families. However, the relative rankings of families within countries are not significantly changed.—There are some few exceptions, but in general, several conclusions may be drawn:

> Despite the generous benefits which some countries provide, families without children are and remain better off than those with children. Transfer payments do not match the costs of raising a child.
>
> It continues to pay to work and work is assumed for almost everyone, everywhere. The presence of an employed wage earner in a family usually far outweighs all possible benefit advantages.
>
> Two-earner families have a dramatic income advantage despite the tax and income support system. Indeed in most places the two-parent, two-child family with one average earner is seen as vulnerable and aided through children allowances.

(Since we have no such supports in the United States, the typical, traditional family ranks very poorly comparatively).

The study defined large families as those with two parents, a working father with an average wage, and four or more children. As seen in Table 2, the countries high in the generosity rankings are France, Sweden, and Germany, in that order, followed by the United Kingdom and Israel; these are countries where the issue of child poverty is constantly discussed publicly. The United States is at the bottom of this ranking, joined only by Australia, a country which employs income testing for all transfers, even what we know as social insurance. In the low-ranking countries total family income for the six member family is barely above that for the four-member, two-parent, average-salary family, despite transfers. The three lead countries, by contrast, boost the four-child family income significantly, even though on a per capita basis, within their own country, the family's relative status remains. The four-child family with a working parent is better off, relatively, within its own country than the single mother and her children, who are dependent completely on the income maintenance system or than all the families with unemployed heads. However, the single mother who is in the labor force, although a low earner, achieves a higher standard for her family than does the two-child two-parent family with an average earner, if her income supplemented by allowances and assistance, as specified below.

3. *The major policy instruments which produce these results are generally shared by countries but there are important variations* which account for some of the country generosity ranking differences. Other differences reflect benefit levels, not availability of programs per se. The most significant programs for families are child or family allowances (but not in the United States), unemployment benefits, and tax policies (see Chart B). As summarized in our final report:

> There are some programs which are unique to individual countries or particularly important in some countries and not in others. Among the unique programs are child support (advance maintenance) in three countries and food stamps in the U.S. Maternity or parental benefits are available everywhere but Australia and the U.S. Four countries have [entitlement] housing allowances; two have refundable tax credits.

4. Especially dramatic is the way in which *public (social) assistance as a policy device varies in significance and in the extent to which it is of use across the countries.* The United States relies heavily on public assistance and food stamps for lack of having adopted useful alternatives.

It should be noted that public assistance programs in most countries are converging on the supplementary benefit pattern, much like SSI in the United States: Nationally run or directed, the programs are characterized by moderate and standardized asset tests, national eligibility standards objectively set, and fewer elements of stigma than in the past. Usually, the supplementary benefit for the aged whose social insurance benefits (pensions or unemployment insurance) are inadequate is in the same program as that for single mothers and children (our AFDC) and for two-parent, low-earner families. England has a separate Family Income Supplement (FIS) to cover low-earner families. In some countries (e.g. Germany) the unemployed who have exhausted unemployment insurance benefits become recipients of a special unemployment assistance, that is income-tested and at a somewhat lower benefit level than unemployment insurance, but standardized.

In addition to this, some places have retained or reestablished the locally administered, highly discretionary, assistance programs of the past, integrated with a social service component, to cope with emergencies, special circumstances, transitions, and program gaps. These are small programs of limited duration.

Public assistance ("welfare") coverage rates are nowhere nearly as high as in the United States and England. (England uses its assistance programs to cover the long-term unemployed, a large group, as well as the aged who need supplementation, single mothers and their children, and single adults unable to "make it" in the labor market).

Nonetheless, each of the countries except France uses some form of public assistance on a significant scale. France substitutes a rich package of family allowances, both income-tested and non-income tested. What is significant here is that the United States, Canada, and Israel employ public assistance in the largest variety of situations of need while Sweden, France, and Germany do so in the fewest. The difference is dramatic. The latter countries have adopted alternatives (see below) and also are the most generous to vulnerable families. Some families which do receive public assistance in such countries as Sweden (the at-home sole mother) are not large groups in the population and the aid is brief.

5. Countries minimize the use of public assistance by a combination of labor market policies (work training or school, with stipends) *and a variety of other income substitutes and income supplementation devices.* Especially important are family (child) allowances, housing allowances, government child support guarantees and, as indicated, unemployment assistance.

Central to these strategies are the income supplementation programs which do not remove work incentives: the universal child or family allowances which are paid at all income levels and the housing allowances which are income-tested but available at a relatively high income level and not stigmatized.[6] The idea is to retain incentives to work in the knowledge that earnings will not affect access to these essential supplements which make the difference between managing and poverty.

Child and family allowances are the most important of these programs. They are universal. France also adds an income-tested unstigmatized flat-rate family income supplement, pitched rather high, to cover those with three or more children or one child under age 3. The United States is the only major country in the world which does not offer any family (children) allowances; other countries recognize the fact that wages are unrelated to family obligations and that the entire society has a stake in the living standards of the next generation.

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[6] Typically a means-tested program requires full disclosure of all income and assets and requires the cashing out of all or most assets before there is eligibility for aid. The applicant usually is subject to thorough and ongoing investigation and checking. The income-tested program declares eligibility for all those below a specified current income level, ignores assets, and allows verification through tax returns, salary slips, or similar simple means.

Income-tested housing allowance entitlements in Germany, France, Sweden, and the United Kingdom reflect the understanding that housing-market dynamics result in rental or price levels beyond the capacity of average earners. These programs are objective, simple, and without stigma. In Sweden and France in particular the combined child allowances and housing allowances add significantly to income. For a single working mother with two children in Sweden the combined supplement is equal to over 20 percent of the average production worker's net wage; it is equal to one-third that wage in France. For the four-child, single-earner family the additions are 56 percent of the net average wage in Sweden and 67 percent in France.

The child support programs, most generous in Sweden among the countries studied, provide an unstigmatized, reliable public guarantee if there has been a court award but the absent parent does not pay. In some countries the program is at the welfare level and not much more detached from the welfare machinery than in the United States. In others, benefits are higher than social assistance and families are made truly better off.

These, then, were some central findings.

USING THE TAX SYSTEM

As indicated earlier, it is now generally understood that in addition to its role in collecting money to meet government commitments, the tax system is a vehicle for explicit and implicit public policy. In the research here summarized, we found the following.

1. The United States and Canada employ the tax system to pay direct transfers to low income families. These are refundable tax credits, returning cash if the indebtedness is below the entitlement. (A U.S. family may receive advance payment if it files with the employer). The U.S. Earned Income Tax Credit (EITC) program was enacted in 1975 at the time of a general tax cut and was intended to offset for certain low-income workers the increased social security payroll tax burden. Four of the family types in the research (single mothers in the labor force,[6] intermittent workers in two-parent families, and people in training programs receiving taxable stipends) proved eligibile for the credit and it constituted between 3.6 to 6.3 percent of total family incomes in New York and between 4.7 to 7.3 percent of the lower family incomes in Pennsylvania. While these are small amounts they are significant income components; in a sense these are an alternative to family allowances for a limited number of low income families even though not designed as such.

The somewhat different Canadian tax credit is specifically intended as a supplement to family allowances targeted at low-income families. (Ontario has its own modest supplementary refundable tax credit that, unlike the Canadian benefit or the U.S.

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[6] Receiving or not receiving child support payments.

EITC, is not limited to families with children. It is intended to offset housing, sales tax and other costs faced by low-income taxpayers.) We found all our family types to be eligible in Canada and total payment levels were not unlike those in the United States.

2. To deal with costs and "efficiency" arguments, several of the countries tax universal benefits, especially unemployment insurance, as part of regular income (Australia, Canada, France, Sweden, The United States). Germany does not tax the benefit nor does Israel which, however, deducts social security contribution (a common practice in several countries). The United States taxation of unemployment benefits had a threshold of $25,000 for couples and $20,000 for individuals until 1981 when the thresholds were reduced to $18,000 and $12,000. In short the taxation did not affect the families in the research. In 1984 the principle of taxing universal benefits moved a step forward in the United States with taxation of a portion of the social security benefit attributable to the employer contribution; this taxation affects only retirees at a relatively high income level. Canada has taxed child allowance since 1972.

3. Several of the countries have refinanced or upgraded their children's or family allowances by eliminating tax exemption for children in the personal income tax. This was done on the premise that such exemptions are of major significance to those with the highest marginal tax rates. A straight allowance or a tax credit targets low income families. Germany created its child benefit program in 1975, replacing both a general child tax exemption (special exemptions for handicapped children and others remain) and a limited family allowance program. The United Kingdom took similar steps in 1977. Israel went even further in 1975, both abolishing child tax exemptions and integrating the new child allowance more fully into the tax system. The child allowance is a universal demogrant at a fixed level and indexed. For families below the tax threshold it is a direct transfer, while for those with income above the tax threshold it becomes a tax credit.

The Israeli family allowance has yet another conceptual innovation: it is calibrated to meet the costs of rearing a child at the poverty level, making it unnecessary to provide for children in the budgets of social insurance or assistance programs. (Thus far, because of economic problems, this principle has not yet been implemented for first and second children).

4. Two countries, the U.S. and Germany, help families meet child care costs (in the U.S. the legislation applies to all dependent care) through a child care tax credit but both the taxpayer and spouse—if married—must be employed or looking for work. As in the case of all tax credits, except the E.I.T.C., such provision is of little use to the very poor but is helpful to some low earners as a supplement.

5. The British deliver some of their housing allowances not as cash but by offering rent rebates (for tenants) and real estate tax rebates for owners.

6. There remain instances in which the tax and transfer systems run on quite separate tracks and are not at all integrated. Thus, there have been a series of recent U.S. reports documenting the increased tax burdens on the lowest quintile of the income distribu-

tion during the last twenty years. This has resulted from: inflation ("bracket creep"); federal, state, and local income tax policies; and, especially, the growing importance of and increases in payroll taxes. At the same time, transfer payment levels have had to be increased to help these overtaxed poor people. At the time of our research, those income-tested benefits in France which favored families with children and low-income people were offset by a personal income tax system which favored high-income families. Redistributional impact was thus minimal. In Germany, the working single mother had so heavy a burden from combined personal income taxes and social security payroll deductions as to almost undo positive transfers and minimize work incentives. This effect was not visible before the research.

FOR THE UNITED STATES DISCUSSION

While one is stimulated in many ways by exposure to the comparative material and the historical perspective, a few points remain outstanding and belong in any review of U.S. options.

First, among the programs which make a difference, *family (child) allowances are central.* Made universal, taxable, and refundable, they would do much for the working poor in particular and for low income families with children generally. Individual exemptions in our tax system have recently been mentioned as needing to be increased because they have long lagged behind inflation. Serious discussion liberated from some political considerations would consider the alternative route of turning child tax exemptions into refundable tax credits. One can think of no more strategic welfare reform. It is difficult to justify the failure only in the U.S. among major countries to employ some form of child allowance.

On the basic policy level, we need to reconsider income supplementation as strategy. The countries that make the least use of public assistance and most successfully encourage low earners, including single mothers, who are low earners, to enter or to remain in the work force are those that help the working poor (and those not yet in the labor force) with universal benefits such as family or child allowances, or with income-tested and non-stigmatized entitlements such as housing allowances, the French family income supplement, and advance maintenance child support programs. The U.S. AFDC and food stamp policies have moved away from income supplementation over the past four years, following a theory that one is either unavoidably dependent or should be compeletely self-sustaining. We are running contrary to societal learning.

Income supplementation may minimize the stigmatized public assistance status which intereferes with mainstreaming. It also does much for the level of living. Dramatic results are shown in our research for working single mothers in New York. Assisted by AFDC supplementation (before the 1981 Omnibus Budget Reconciliation Act changes), and by food stamps, as well as the Earned Income Tax Credit, they were able to sustain their children at a level that was relatively respectable in the international comparison. Few U.S. families among the vulnerable compared so favorably.

One aspect of the above needs emphasis. Humane, generous, progressive countries have recognized that some programs may be too costly when universal. They have therefore successfully developed income testing without stigma. Our student loan programs are an example: one is eligible if family income is below a specified level. There is no detailed study of means, no demand for divestiture of assets. Housing allowances, family income supplements and other programs have developed in several countries on this basis and have—along with family allowances—become the core of income supplementation strategies.

The alternative and related approach to controlling costs and achieving a level of economic efficiency is to tax universal benefits. We have begun with unemployment insurance and social security payments above a high ceiling. Some countries have gone further but the picture is mixed. The rationale of those favoring taxing universal benefits would appear to be straightforward: all of current income should be taxed if it has not previously been taxed—and a fair system taxes all income.

We have not found encouragement for a search for one, comprehensive, income maintenance reform (a new philosopher's stone to replace the defeated "negative income tax"). Countries seem to do better with a diversity of instruments, packaged to give each population category a targeted "menu", responsive to social objectives.

A final point needs to be made, however briefly. Obviously, wealthy countries generally do more than poor countries but there are important exceptions. Countries do follow different priority systems. Nor is there any evidence that generous countries hurt their economies, increase their birth rates, undermine their family structures, or destroy the work ethic. What they do achieve is some improvement in the support of their vulnerable citizens, thus offering better developmental opportunity to their current and next generations. This is not an uninteresting objective.

CHART A.—FAMILY TYPES

Family 1a	Sole parent, not in labor force; two children, aged two and seven. (These ages apply to all children, except in Family 6, where there are two additional children aged three and five.)
Family 2a	Sole parent, separated; employed at half an average wage, two children.
Family 2b	Same as Family 2a but father contributes amount equal to double the amount paid for child allowance for one child, one year (twice AFDC allowance in the U.S.).
Family 3a	Two parents; one earner at average wage; two children.
Family 3b	Same as Family 3a, but earner works irregularly at half an average wage.
Family 4a	Two parents; one unemployed earner; two children.
Family 4b	Same as Family 4a, but earner is on a work-training program.
Family 4c	Same as Family 4a, but earner is unemployed for 13 months.
Family 5a	Two parents; two earners, one at average wage and the other at half an average wage; two children.
Family 5b	Same as Family 5a, but one parent earns an average wage and the other twice the average wage.
Family 5c	Same as Family 5a, but one parent is unemployed.
Family 6	Two parents; one earner at average wage; four children.
Family 7a	A married couple; one earner at average wage; no children.
Family 7b	Two parents; two earners, one at average wage; the other at three-quarters of an average wage; mother home on maternity leave; infant born.
Family 7c	Same as Family 7a, except husband unemployed and wife earning an average wage.

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CHART B.—"CORE" INCOME TRANSFER PROGRAMS, BY COUNTRY

Country	Family (child) allowance	Housing allowance	Social assistance	Child support (government)	Unemployment insurance	Other unemployment benefits	Child allowance supplement	Food stamps	Refundable tax credits	Maternity benefits
Sweden	X	X	X	X	X	X [2]				X
Germany	X	X	X	X	X	X [3]				X
United States-New York.			X		X			X	X	X
United States-Pennsylvania.			X		X			X		
France	X	X	X	X	X		X			
Canada	X		X		X				X	X
Australia [1]	X		X			X [3]				
United Kingdom	X	X	X		X					X
Israel	X		X	X	X					X

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[1] We classify Australia under unemployment assistance and social assistance even though one could debate just how these income-tested benefits should be regarded.

[2] Labor market assistance.

[3] Unemployment assistance.

Note: We use generic names for programs and ignore what are significance distinctions. For example, the British child benefit is not the same as the German child allowance; the Swedish advance maintenance grant is quite different from the Israeli alimony payment.

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TABLE 1.—INTERCOUNTRY COMPARISONS: GENEROSITY TO DIFFERENT FAMILY TYPES AS COMPARED WITH NET INCOME OF AVERAGE UNMARRIED PRODUCTION WORKER [APWW] [1]

Countries	Family types														
	1a	2a	2b	3a	3b	4a	4b	4c	5a	5b	5c	6	7a	7b	7c
Sweden	93.8	123.1	123.1	133.1	122.6	121.2	124.2	116.5	170.0	258.1	163.0	164.1	103.4	155.0	190.7
Germany	67.3	70.9	76.3	119.7	87.5	89.0	99.0	81.2	167.1	275.2	141.0	148.0	110.0	149.1	174.0
United States-New York	54.9	100.8	100.8	111.8	92.2	70.0	77.0	65.6	155.8	260.3	130.2	116.4	107.0	116.8	133.5
United States-Pennsylvania	44.0	69.2	75.3	109.6	72.9	67.2	64.5	53.9	156.8	271.9	132.0	113.0	106.2	107.9	146.4
France	78.6	87.8	103.4	136.9	93.0	101.1	104.5	112.7	180.8	310.3	180.9	172.6	107.9	151.5	179.9
Canada	52.5	75.9	75.5	114.2	73.0	76.8	76.3	55.8	165.0	289.1	141.9	123.5	104.9	121.5	154.1
Australia	50.0	78.8	82.1	107.2	79.7	64.3	81.4	6[illegible].3	155.9	269.8	107.2	113.7	102.6	104.0	102.6
United Kingdom	51.7	83.0	91.6	120.4	80.9	74.1	105.4	65.3	177.3	324.3	153.9	131.6	109.2	134.5	151.0
Israel	50.0	71.5	80.1	112.9	86.4	67.9	70.1	54.9	171.5	286.8	126.5	132.4	104.3	124.8	123.6

[1] Net APWW = 100. Countries are listed in order of average income (per capita GNP), which in 1979 ranged from $11,920 for Sweden and $10,820 for United States to $6,340 for United Kingdom and $4,170 for Israel.

TABLE 2.—INTERCOUNTRY COMPARISONS: GENEROSITY TO DIFFERENT FAMILY TYPES AS COMPARED WITH NET INCOME OF AVERAGE UNMARRIED PRODUCTION WORKER (RANKINGS) [1]

Countries	Family types														
	1a	2a	2b	3a	3b	4a	4b	4c	5a	5b	5c	6	7a	7b	7c
Sw[illegible]	1.0	1.0	1.0	2.0	1.0	1.0	1.0	1.0	4	9	2.0	2.0	8.5	1	1
Ge[illegible]y	3.0	7.5	7.0	3.5	4.0	3.0	4.0	3.0	5	5	4.5	3.0	1.5	3	3
Un[illegible] States–New York	4.0	2.0	3.0	7.0	3.0	6.0	6.5	4.5	8	8	7.0	7.0	4.5	7	7
United States–Pennsylvania	9.0	9.0	8.5	8.0	8.5	7.5	9.0	9.0	8	6	6.0	8.5	4.5	8	6
Fra[illegible]	2.0	3.0	2.0	1.0	2.0	2.0	2.5	2.0	1	2	1.0	1.0	3.0	2	2
Ca[illegible]	5.0	6.0	8.5	5.0	8.5	4.0	6.5	7.5	6	3	4.5	6.0	6.5	6	4
Aus[illegible]	7.5	5.0	5.0	9.0	7.0	9.0	5.0	6.0	8	7	9.0	8.5	8.5	9	9
Uni[illegible] Kingdom	6.0	4.0	4.0	3.5	6.0	5.0	2.5	4.5	2	1	3.0	4.5	1.5	4	5
Israel	7.5	7.5	6.0	6.0	5.0	7.5	8.0	7.5	3	4	8.0	4.5	6.5	5	8

[illegible]anks defined as ties unless the ratios (annual income as percent of net APWW) differ by 1 percent.

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TABLE 3.—THE AVERAGE GENEROSITY RANKS OF TARGET FAMILIES [1] AND CONTRAST FAMILIES [2] IN EIGHT COUNTRIES

Country	Ranks	
	Target families	Contrast families
Sweden	1	8
Germany	3	3
United States–New York	5	7
United States–Pennsylvania	9	6
France	2	2
Canada	6	5
Australia	8	9
United Kingdom	4	1
Israel	7	4

[1] Families include: la, 2a, 2b, 3a, 3b, 4a, 4b, 4c, 6 (see Chart A).
[2] Families include: 5a, 5b, 7a (see Chart A).

TABLE 4.—INTER-COUNTRY COMPARISONS: SOCIAL ASSISTANCE AS A PERCENT OF FAMILY INCOME

Country	1a	2a	2b	3b	4a	4b	4c	6	Number of family types receiving
Sweden	36.1			22.7			71.6	4.0	4
Germany	(1)			6.7					1
United States–New York	79.5	28.5	14.1	22.5	37.5	11.2	78.9		7
United States–Pennsylvania	77.6	6.9			25.6		75.6		4
France	[2] 52.4			1.0			8.8		3
Canada	80.0	4.1	0.08		4.5		80.8		5
Australia	90.8	23.5	20.2						3
United Kingdom	72.9						82.8		2
Israel	82.9			26.8	28.5		84.4		4
Number of jurisdictions offering	8	4	3	5	4	1	7	1	33

[1] Germany: This family receives unemployment insurance.
[2] France: Lone-parent allowance (technically, a family allowance).

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THE INCIDENCE OF A VALUE-ADDED TAX ON THE FAMILY

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ABSTRACT

A value-added tax (VAT), like most taxes on consumer expenditures, would be regressive since lower income families spend a higher percentage of their incomes than higher income families. In this report, the tax incidence of VATs with different tax bases is measured by both family income quintile and family composition.

I. INTRODUCTION

The large unified budget deficits forecast for fiscal year 1986 and future fiscal years have raised congressional concern about their possibly harmful macroeconomic effects. Consequently, a value-added tax (VAT) at the Federal level has been proposed as a major revenue source which would reduce projected deficits.

This report examines the incidence of a value-added tax on the family unit and explains possible policies to change this incidence. The incidence of any tax concerns who ultimately bears the burden of that tax. The concept of a value-added tax is explained briefly below before the incidence of a VAT is examined.

A. CONCEPT OF A VALUE-ADDED TAX

The value added by a firm is the difference between a firm's sales and a firm's purchases from all other firms. A value-added tax would be levied at all levels of production as some percentage of each firm's value added.[1]

The cumulative effect of a value-added tax levied at each stage of production would have the same incidence as a national sales tax. Hence, a consumption VAT of a given percentage is assumed to raise the prices of taxed goods and services by the same percentage. Policymakers and professional economists use the operating assumption that a VAT is fully shifted onto final consumers.

B. HORIZONTAL EQUITY, VERTICAL EQUITY, AND REGRESSIVITY

Two equity considerations concerning any tax are horizontal equity and vertical equity. Horizontal equity concerns the equal treatment of equals. For this report, horizontal equity exists if families with the same incomes pay the same percentage of their incomes in value-added taxes. Vertical equity concerns the tax treat-

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[1] For an explanation of the different types of VATs, see: Advisory Commission on Intergovernmental Relations. Strengthening the Federal Revenue System: Implications for State and Local Taxing and Borrowing. Washington, 1984. p. 69–71. (Hereafter referred to as ACIR, Strengthening: Implications)

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ment of unequals. For this report, vertical equity relates to the percent of family income paid in value-added taxes at different income levels.

The most frequently used measure of ability-to-pay is income measured in annual terms.[2] Consequently, this report uses annual family income as a measure of ability-to-pay.

A value-added tax would be horizontally inequitable to the extent that families with the same income levels paid different amounts of taxes since they would have different levels of taxable consumption.[3]

This report's analysis of the vertical equity of the VAT finds that the VAT is regressive, that is, the percentage of income paid in VAT declines as income rises. This report focuses on the zero rating technique (selectively excluding items from VAT) to reduce the regressivity of the VAT. Also the VAT's incidence on families with different compositions is analyzed with different items zero rated.

C. METHODS OF REDUCING REGRESSIVITY

The best distributional or vertical equity of a particular tax is a value judgment, but many people may be concerned about the regressivity of the VAT. Three methods that can be used are income tax credits, the partial linkage of revenues to social spending, and zero rating.[4]

1. Income Tax Credit.—An income tax credit applied against a family's Federal income tax liability could reduce VAT's regressivity. At the State level, two types of income tax credits are applied for State sales taxes. Either type could be used to allow a credit for VAT paid against a Federal income tax liability. First, a flat income tax credit, which would equal some set dollar amount, could be credited against a Federal income tax liability. Second, a declining tax credit, which would decrease in size as adjusted gross income rose, could be applied against a Federal income tax liability. For a given revenue loss, a declining tax credit could reduce the regressivity of a Federal VAT more than a flat income tax credit, since higher income families would benefit less from a declining tax credit. Also, an income tax credit could adjust the incidence of a VAT for family size by varying the amount of the total credit based on family size.

The primary disadvantage of this income tax credit procedure is that many lower income families may not file to receive a tax rebate. These families may be ignorant of their opportunities to obtain a tax rebate or hesitant to provide tax authorities with information about their financial affairs.

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[2] For an analysis of the use of income or consumption to measure ability to-pay see: Musgrave, Richard A., and Peggy B. Musgrave. Public Finance in Theory and Practice. New York, McGraw-Hill, 1984. p. 227-244.

[3] If consumption, instead of income, is used to measure ability-to-pay, then a comprehensive VAT would be horizontally equitable.

[4] These same methods also apply to the reduction of the regressivity of a national sales tax. The application of these methods to a national sales tax is explained in: U.S. Library of Congress. Congressional Research Service. National Sales Tax: Selected Policy Issues, by James M. Bickley. Report no. 84-141 E. Washington, 1984. p. 32-35.

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2. Partial Linkage of Revenue to Social Spending.—A set amount or percentage of the revenue from a Federal VAT could be set aside to either increase, or prevent reductions in, social spending benefiting lower income families. For example, funding of Aid to Families with Dependent Children (AFDC) and Medicaid could be increased. Thus, lower income families, on the average, could receive more in additional public services and cash payments than they pay in value-added taxes.

This method of partially linking revenue to social spending has two limitations. First, the effectiveness of many social programs is disputed; consequently, poor families may receive benefits that are equal to only a fraction of a welfare program's total outlays. Second, many low income families do not benefit from welfare programs because they either do not qualify or are unaware of their opportunity to apply.

3. Zero Rating.—The regressivity of a value-added tax can be reduced by zero rating selective goods and services that account for a greater percentage of the incomes of lower income families than higher income families. Zero rating completely excludes a good (or service) from the value-added tax. Consequently, a zero-rated good or service does not change in price. A seller pays no VAT on a zero-rated good or service and receives a tax credit on any inputs used to produce that good or service.[5] Zero rating an item, such as food, for a Federal VAT would be analogous to a State exempting food from its sales tax.

D. DATA BASE

The recently-released results of the 1980–81 Consumer Expenditure Survey (CES) may be used to measure the incidence of VAT. Residents of approximately 5,000 housing units were interviewed about their recent consumer expenditures. The results of the CES include data on consumption patterns by both income quintile and family composition.

II. Overview of Data Base

A. DATA DESCRIPTION

The primary purpose of the 1980–81 Consumer Expenditure Survey, conducted by the Bureau of Labor Statistics (BLS), was "to obtain a continuous flow of information on the buying habits of American consumers . . ."[6] One use of this BLS consumer survey is to make future revisions in the consumer price index. The consumer survey has an interview component and a diary component. Since only limited data from the diary component have been published, this report relied solely on the results of the interview com-

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[5] This report makes the technical distinction between zero rating and exemption for a VAT, but many tax authorities define exemption as meaning totally excluding a good from a VAT (or the equivalence of zero rating). Technically, the sale of an exempt good is not taxable, but the seller receives no credit for VAT paid on inputs needed to produce that good. For a technical discussion of the difference between zero rating and exemption see: U.S. Treasury. Tax Reform for Fairness, Simplicity, and Economic Growth. Volume 3, Value-Added Tax. Washington, November 1984. p. 39–42.

[6] U.S. Department of Labor. Bureau of Labor Statistics. Consumer Expenditure Survey: Results from the 1980–81 Interview. Washington, December 19, 1984. p. 2.

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ponent. Residents in approximately 5,000 housing units from 85 urban areas were interviewed each quarter. Respondents were questioned on expenditures made during the previous 3 months.[7]

The BLS has specific definitions for many terms used in its Consumer Expenditure Survey. These terms and their definitions are:

Consumer Unit.—A single person or group of persons in a sample household related by blood, marriage, adoption or other legal arrangement, or who share responsibility for at least two out of three major types of expenses—food, housing, and other expenses. The term households is used for convenience.

Householder or Reference Person.—The first member mentioned by the respondent when asked to "Start with the name of the person or one of the persons who owns or rents the home." It is with respect to this person that the relationship of other consumer unit members is determined.

Total Expenditures.—The transaction cost, including excise and sales taxes, of goods and services acquired during the interview period. Estimates include expenditures for gifts and contributions, and payments for pensions and personal insurance.

Complete Income Reporters.—In general, a consumer unit who provided values for at least one of the major sources of its income, such as wages and salaries, self-employment income, and social security income. Even complete income reporters may not have provided a full accounting of all sources.

Quintiles of Income Before Taxes.—Complete income reporters are ranked in ascending order of income value and divided into five equal groups.

Urban Population.—All persons living in Standard Metropolitan Statistical Areas plus urbanized areas and urban places of 2,500 or more persons outside of SMSAs.[8]

B. DATA

This CRS report concerns the incidence of a VAT on the family unit. Hence, for the purposes of this report, a consumer unit is considered the same as a family unit. Data in table 1 describe characteristics of consumer (family) units by quintiles of income before taxes. Also, table 1 shows total expenditures on specific items in dollar terms by quintiles of income before taxes. In table 2, the dollar expenditures data from table 1 are converted into expenditures as a percentage of income.

TABLE 1.—AVERAGE ANNUAL EXPENDITURES OF URBAN CONSUMER UNITS CLASSIFIED BY QUINTILES OF INCOME BEFORE TAXES, INTERVIEW SURVEY, 1980–81

Item	Complete reporting of income					
	Total complete reporting	Lowest 20 percent	Second 20 percent	Third 20 percent	Fourth 20 percent	Highest 20 percent
Number of CU's (in thousands)	57,337	11,426	11,480	11,456	11,475	11,501
Consumer unit characteristics:						
Income before taxes	$19,989	$3,473	$9,791	$16,809	$25,128	$44,616

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[7] Ibid.

[8] BLS, Consumer Survey: Results 1980–81, p. 3.

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TABLE 1.—AVERAGE ANNUAL EXPENDITURES OF URBAN CONSUMER UNITS CLASSIFIED BY QUINTILES OF INCOME BEFORE TAXES, INTERVIEW SURVEY, 1980–81—Continued

Item	Complete reporting of income					
	Total complete reporting	Lowest 20 percent	Second 20 percent	Third 20 percent	Fourth 20 percent	Highest 20 percent
Size of consumer unit	2.7	1.8	2.3	2.7	3.2	3.4
Age of householder	45.3	51.8	46.4	42.3	41.4	44.6
Number in consumer unit:						
Earners	1.4	0.6	1.0	1.5	1.8	2.2
Vehicles	1.9	0.7	1.4	1.9	2.4	2.9
Children under 18	0.8	0.4	0.6	0.8	1.0	1.0
Persons 65 and over	0.3	0.5	0.4	0.2	0.1	0.1
Percent homeowner (percent)	60	36	46	57	74	88
Total expenditures	$17,301	$7,852	$11,570	$15,736	$20,714	$30,563
Food	3,201	1,820	2,452	3,028	3,737	4,959
Alcoholic beverages	284	129	221	281	329	460
Housing	5,016	2,682	3,605	4,448	5,810	8,516
Shelter	2,797	1,526	2,002	2,457	3,233	4,757
Owned dwellings	1,627	501	727	1,180	2,154	3,564
Rented dwellings	933	926	1,173	1,130	826	610
Other lodging	237	99	102	147	253	584
Fuels, utilities, and public services	1,246	739	995	1,210	1,466	1,814
Household operations	257	155	211	165	250	500
House furnishings and equipment	716	261	398	616	860	1,445
Apparel and services	941	396	569	810	1,075	1,851
Transportation	3,486	1,251	2,278	3,377	4,461	6,050
Vehicles	1,174	379	697	1,078	1,593	2,117
Gasoline and motor oil	1,197	453	857	1,235	1,543	1,893
Other vehicle expenses	897	291	568	883	1,145	1,594
Public transportation	218	128	156	181	179	446
Health care	729	476	595	700	807	1,066
Entertainment	768	263	440	679	916	1,535
Personal care	156	77	111	139	178	272
Reading	117	55	77	110	139	206
Education	214	170	84	116	200	498
Tobacco	178	101	164	191	215	217
Miscellaneous	250	100	141	232	293	482
Cash contributions	527	161	273	429	562	1,209
Personal insurance and pensions	1,434	170	559	1,195	1,993	3,241

Source: U.S. Department of Labor. Bureau of Labor Statistics. Consumer Expenditure Survey: Results from the 1980–81 Interview. Washington, 1984. p. 4.

TABLE 2.—CONSUMER EXPENDITURES, AS PERCENT OF URBAN FAMILY INCOME, BEFORE TAXES. INTERVIEW SURVEY, 1980–81

Item	Complete reporting of income					
	Total complete reporting	Lowest 20 percent	Second 20 percent	Third 20 percent	Fourth 20 percent	Highest 20 percent
Income before taxes (dollars in thousands)	$19,989	$3,473	$9,791	$16,809	$25,128	$44,616
Total expenditures (as percent of income)	86.6	226.1	118.2	93.6	82.4	68.5
Food	16.0	52.4	25.0	18.0	14.9	11.1
Alcoholic beverages	1.4	3.7	2.3	1.7	1.3	1.0
Housing	25.1	77.2	36.8	26.5	23.1	19.1
Shelter	14.0	43.9	20.4	14.6	12.9	10.7
Owned dwellings	8.1	14.4	7.4	7.0	8.6	8.0
Rented dwellings	4.7	26.7	12.0	6.7	3.3	1.4
Other lodging	1.2	2.9	1.0	.9	1.0	1.3
Fuels, utilities, and public services	6.2	21.3	10.2	7.2	5.8	4.1
Household operations	1.3	4.5	2.2	1.0	1.0	1.1

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TABLE 2.—CONSUMER EXPENDITURES, AS PERCENT OF URBAN FAMILY INCOME, BEFORE TAXES, INTERVIEW SURVEY, 1980–81—Continued

Item	Complete reporting of income					
	Total complete reporting	Lowest 20 percent	Second 20 percent	Third 20 percent	Fourth 20 percent	Highest 20 percent
House furnishings and equipment	3.6	7.5	4.1	3.7	3.6	3.2
Apparel and services	4.7	11.4	5.8	4.8	4.3	4.1
Transportation	17.4	36.0	23.3	20.1	17.8	13.6
Vehicles	5.9	20.1	7.1	6.4	6.3	4.7
Gasoline and motor oil	6.0	13.0	8.8	7.3	6.1	4.2
Other vehicles expenses	4.5	8.4	5.8	5.3	4.6	3.6
Public transportation	1.1	3.7	1.6	1.0	.7	1.0
Health care	3.6	13.7	6.1	4.2	3.2	2.6
Entertainment	3.8	7.6	4.5	4.0	3.6	3.4
Personal care	.8	2.2	1.1	.8	.7	.6
Reading	.6	1.6	.8	.7	.6	.5
Education	1.1	4.9	.9	.7	.8	1.1
Tobacco	.9	2.9	1.7	1.1	.9	.5
Miscellaneous	1.3	2.9	1.6	1.4	1.2	1.1
Cash contributions	2.6	4.6	2.8	2.6	2.2	2.7
Personal insurance and pensions	7.2	4.9	5.7	7.1	7.9	7.3

Source: CRS calculations of percentages are based on U.S. Department of Labor. Bureau of Labor Statistics. Consumer Expenditure Survey: Results from the 1980–81 Interview. Washington, 1984. p. 4.

C. LIMITATIONS OF DATA

CES data should be interpreted with care. These data represent averages, and, consequently, an expenditure or characteristic of a particular consumer unit may differ substantially from the average. The level and composition of a consumer unit's expenditures are influenced by many factors in addition to income before taxes. Some of these factors are size of family, age of family members, taste patterns, and geographic location.[9]

In addition, these data are 2 to 4 years old, which reduces their current applicability[10] Also, only urban consumer units are included in the survey. Consumption patterns in smaller communities and rural areas may differ significantly from urban areas. Furthermore, the interview survey was designed to gather data on the types of expenditures that respondents would be expected to recall for a period of three months. Thus, some small and infrequently purchased items, such as non-prescription drugs and personal care items, were not in the survey. But these items accounted for only about 5 percent of total consumer outlays.[11]

Finally, all survey research is subject to two types of errors. First, non-sampling errors may result from inaccurate information being recorded. For example, some respondents may be unable or unwilling to provide correct data. Second, the sample results may not reflect averages for the entire population (all urban consumer units).[12]

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[9] BLS, Consumer Survey: Results 1980–81, p. 3

[10] The Advisory Commission on Intergovernmental Relations (ACIR) analyzed the regressivity of the VAT using data from the 1972–73 Interview Survey on Consumer Expenditures which was done by the Bureau of Labor Statistics. For the analysis of the ACIR, see: ACIR, Strengthening: Implications, p. 84–86.

[11] BLS, Consumer Survey: Results 1980–81, p. 2.

[12] Ibid., p. 3.

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D. MEASUREMENT OF REGRESSIVITY

The expenditive percentages on line 2 in table 2 show that the percentage of family income spent on consumption declines as income rises. By implication, a VAT covering all family expenditures would be regressive, that is, as family income rises the percentage of family income paid in VAT would decline.

Two factors cause the regressivity of the VAT to be overstated by the data in table 2. First, the degree of regressivity is greater because income and consumption are measured in annual terms. For an average family, income tends to vary more from year to year than consumption does. For example, during a period of unemployment of the primary wage earner, income drops sharply. But consumption is likely to fall by a smaller percentage as a family attempts to maintain its previous living standards by spending savings and borrowing funds.

Hence, if income and consumption were measured in a multiyear period, then there would be less variation among families in the percentage of income spent on comsumption and this measurement would show a VAT to be less regressive.

Second, table 1 indicates that as income before taxes (second row of figures) rises, the average size of the consumer unit (third row of figures) also rises. The average sizes of consumer unit by quintiles of income before taxes starting with the lowest quintile are 1.8, 2.3, 2.7, 3.2, and 3.4 persons, respectively. Since the comsumption shown in tables 1 and 2 is not adjusted for differences in the size of the consumer unit, the implied regressivity of the corresponding VAT is overstated. But no standard procedure is available to adjust income for the size of the consumer unit.

III. ZERO RATING: DISTRIBUTIONAL EFFECTS BY INCOME QUINTILE

Different tax bases for a value-added tax (or a national sales tax) were examined to determine possible items that could be zero rated on equity grounds.[13] Selectively zero rating consumer items may reduce the inequality among family income quintiles. Table 2 shows the distribution of consumption expenditures in percentage terms for the income quintiles. Data form table 2 was used to calculate the incidence of four hypothetical tax bases that were developed by zero rating different consumption items. This author used his judgment to formulate these hypothetical VAT bases. Obviously, a policymaker would select one of these hypothetical VAT bases or formulate another VAT base by zero rating some other combination of items.

In table 3, the distributional effects of a VAT on all consumer expenditures and four hypothetical tax bases are shown. The VAT indicated in column 2 is levied on all consumer expenditures. The

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[13] For examples of proposed VATs or national sales taxes with comprehensive bases see: McLure, Charles E. Value-Added Tax: Has the Time Come? In: Walker, Charles E., and Mark A. Bloomfield, eds. New Directions in Federal Tax Policy for the 1980s. Cambridges, Mass., Ballinger Publishing Co., 1983, p. 192; U.S. Treasury. Tax Reforms for Fairness Simplicity, and Economic Growth. v. 3, Value-Added Tax. p. 85-87; and Advisory Commission on Intergovernmental Relations. Strengthening the Federal Revenue System: Implications for State and Local Taxing and Borrowing. p. 70; and Musgrave and Musgrave, Public Finance, p. 436-437.

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VAT base in column 3 only zero rates food. The VAT bases in columns 4 through 6 successively zero rate additional items.

The distributional effects of a VAT, using each of these five bases, can be compared if the tax rate for each VAT is adjusted so that each hypothetical VAT yields the same revenue. In table 3, a VAT rate of 5 percent was assumed if all consumer expenditures are subject to the VAT. The last row of column 2a shows that consumer expenditures equal to 86.6 percent of the average income of all family units would be subject to the value-added tax, and families would pay an average of 4.3 percent of their incomes in value-added taxes. Figures in columns 2b show that the percentage of income paid in VAT taxes declines from a high of 11.3 percent of income for families in the lowest quintile to 3.4 percent of income for families in the highest quintile.

The last figure in column 3a indicates that a VAT with food zero rated would be levied on consumer expenditures equalling 70.6 percent of all familiy income. The VAT with food zero rated would require a 6.135 percent tax rate to yield the same revenue as a 5 percent VAT on all consumer expenditures.

A comparison of figures in columns 2b and 3b indicates that zero rating food reduces the regressivity of a VAT. But the only pronounced change in the percentage of income paid in VAT occurs at the lowest quintile. For this lowest quintile, the percent of family income paid in VAT falls from 11.3 percent to 10.7 percent of income if food is zero rated.

In column 4, this narrower VAT base zero rates food, shelter owned dwellings, shelter rented dwellings, and health care. Shelter owned dwellings are housing units owned by the occupant, and shelter rented dwellings are rental housing units. For this VAT base, a tax rate of 7.990 percent would raise the same revenue as a 5 percent VAT on all consumer expenditures. The only pronounced effect on the distribution of income occurs at the lowest quintile. For this quintile, VAT paid declines to 9.5 percent of income.

In column 5, zero rated items are increased by including the following additional items: fuel, utilities, public services, and tobacco. For this VAT base, a tax rate of 9.195 is levied to raise the same revenue as a 5 percent VAT on all consumer expenditures. The only substantial change in the distribution of income occurs for the lowest quintile. For this quintile, the percentage of income paid in VAT declines to 8.7 percent.

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TABLE 3.—DISTRIBUTION EFFECT BY INCOME QUINTILES OF VALUE-ADDED TAXES WITH EQUAL REVENUE YIELDS BUT DIFFERENT TAX BASES

[Revenues equal to a 5-percent VAT on all consumer expenditures or 4.3 percent of income]

1—Family income quintiles (complete reporting of income)	2—VAT on all consumer expenditures (VAT rate = 5.0)		3—VAT on all consumer expenditures except food (VAT rate = 6.135)		4—VAT on all consumer expenditures except food, shelter-owned dwellings, shelter-rented dwellings, and health care (VAT rate = 7.990)		5—VAT on all consumer expenditures except items in column 4 and fuels, utilities, public services, and tobacco (VAT rate = 9.195)		6—VAT on all consumer expendiatures except items in column 5 and public transportation and education (VAT rate = 9.645)	
	2a [1]	2b [2]	3a [1]	3b [2]	4a [1]	4b [2]	5a [1]	5b [2]	6a [1]	6b [2]
Lowest 20 percent	226.1	11.3	173.7	10.7	118.9	9.5	94.7	8.7	86.1	8.3
Second 20 percent	118.2	5.9	93.2	5.7	67.7	5.4	55.8	5.1	53.3	5.1
Third 20 percent	93.6	4.7	75.6	4.6	57.7	4.6	49.4	4.5	46.9	4.5
Fourth 20 percent	82.4	4.1	67.5	4.1	52.4	4.2	45.7	4.2	44.2	4.3
Highest 20 percent	68.5	3.4	57.4	3.5	45.6	3.6	41.0	3.8	38.9	3.8
All family units (percent)	86.6	4.3	70.6	4.3	54.2	4.3	47.1	4.3	44.9	4.3

[1] VAT base as percent of income.
[2] VAT yield as percent of income.

Source: CRS calculations based on data in: U.S. Department of Labor. Bureau of Labor Statistics. Consumer Expedition Survey: Results from the 1980–81 Interview. Washington, 1984. p. 4, 9.

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Finally, if public transportation and education are added to previously zero rated items, a VAT rate of 9.645 percent is required to raise the same revenue as a 5 percent VAT on all consumer expenditures. The only pronounced change in the distribution of income is for the lowest quintile which has a drop in its percentage of income paid in VAT to 8.3 percent.

The figures in columns 2b and 6b allow a comparison between the distributional effects of a VAT on all consumer expenditures and a narrow based VAT that zero rates food, shelter owned dwellings, shelter rented dwellings, health care, fuels, utilities, public services, tobacco, public transportation, and education. For the lowest quintile, the percent of income paid in VAT declines substantially from 11.3 percent to 8.3 percent. The second lowest quintile has a reduction in VAT paid as a percentage of income from 5.9 percent to 5.1 percent. The declining tax incidence for these two lowest quintiles significantly reduces the regressivity of the VAT.

The middle income quintile has a slight reduction in its VAT paid as a percent of income from 4.7 percent to 4.5 percent. The second highest quintile experiences a rise from 4.1 percent to 4.3 percent in the percentage of income paid in VAT. The highest quintile has a rise in its percentage of income paid in VAT from 3.4 percent to 3.8 percent.

In conclusion, selectively zero rating items on equity grounds can substantially reduce the burden of a VAT on the poor, but even a narrow-based VAT has pronounced regressivity.

This zero rating procedure has two primary disadvantages. First, zero rating increases the administrative complexity of the VAT. Second, zero rating alters the relative prices of goods and services which causes distortions in family consumption decisions. As more items are zero rated, the tax rate must be raised in order for the VAT to yield a given amount of revenue. But the higher the VAT rate the greater the wedge of distortion between taxes and nontaxed items. Hence, a tradeoff exists between reducing regressivity and lessening economic distortions.

IV. Zero Rating: Distributional Effects According to Family Composition

Selectively zero rating items to alleviate the regressivity of a VAT will also have distributional effects on families with different compositions. Table 4 reports data on family unit characteristics and expenditures for different types of families.[14] The average income level for husband and wife families is more than double that of families consisting of either one parent with at least one child under 18 or a single person. Average family income varies less among families with different compositions than among families in different income quintiles. Consequently, the percentage of income paid in VAT levied on all consumer expenditures varies

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[14] In table 4, the BLS used only income of complete income reporters for the income figures in row 2. But the BLS included consumption expenditures of families that were either complete or incomplete income reporters in table 4. The quintiles of income used in tables 1, 2, and 3 used only complete income reporters for both income and expenditures calculations. Hence, the BLS used fewer families in analyzing expenditures by income quintile than in analyzing expenditures by family composition.

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less for families with different compositions than for families in different income quintiles. The data on expenditures in table 4 can be used to suggest the distributional effects of VATs on families with different compositions. But the analysis in this chapter does not concern horizontal equity since the average incomes differ for families with different compositions. In Chapter III, five different VAT bases were used to examine the distributional effects of VATs on family income quintiles. These same VAT bases are used in table 5 to measure the distributional effects by family composition. As in table 3, the VAT rates in table 5 are adjusted for different VAT bases so that each VAT yields the same revenue.

In table 5, column 2b indicates, according to family composition, the percentage of income paid in a 5 percent VAT levied on all consumer expenditures. The average for families over all is 4.3 percent of family income. For all husband and wife families, the percentage of family income paid in VAT is 4.1 percent. The average percentage of family income paid in VAT varies only slightly among husband and wife families with different compositions.

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TABLE 4.—AVERAGE ANNUAL EXPENDITURES OF URBAN FAMILY UNITS CLASSIFIED BY COMPOSITION OF FAMILY UNIT. INTERVIEW SURVEY, 1980–81

Item	All family units	Husband and wife families						One parent, at least one child under 18	Single person and other families
		Total husband and wife families	Husband and wife only	Oldest child under 6	Oldest child 6 to 7	Oldest child 18 or over	Other husband and wife families		
Number of family units (in thousands)	68,295	39,834	14,826	5,003	10,564	6,515	2,926	3,883	24,579
Family unit characteristics:									
Income before taxes [1]	$19,989	$25,831	$22,470	$21,917	$27,347	$33,085	$28,504	$11,093	$12,108
Size of family unit	2.7	3.3	2.0	3.4	4.2	4.1	5.0	3.1	1.5
Age of householder	46.2	46.1	54.1	29.3	38.8	52.3	47.4	35.3	48.1
Number in family Unit:									
Earners	1.4	1.8	1.2	1.6	1.9	2.8	2.5	1.1	0.9
Vehicles	1.9	2.5	2.0	2.1	2.6	3.3	2.7	1.0	1.0
Children under 18	0.7	1.0	0.0	1.4	2.2	0.7	1.6	1.8	0.1
Persons 65 or over	0.3	0.3	0.6	0.0	0.0	0.1	0.5	0.0	0.4
Percent homeowner	61	79	78	62	81	90	77	36	38
Total expenditures	$17,144	$21,173	$17,959	$18,605	$23,054	$26,146	$23,993	$12,066	$11,417
Food	3,224	3,966	3,153	3,188	4,486	5,204	4,783	2,753	2,097
Alcoholic beverages	280	281	281	233	268	332	298	120	303
Housing	5,051	6,016	5,349	6,264	6,635	6,140	6,460	4,191	3,623
Shelter	2,816	3,255	2,936	3,620	3,646	3,097	3,190	2,408	2,169
Owned dwellings	1,655	2,285	1,933	2,407	2,781	2,215	2,225	875	757
Rented dwellings	913	649	637	1,036	587	475	665	1,433	1,259
Other lodging	248	321	366	176	278	407	301	100	153
Fuels, utilities and public services	1,263	1,538	1,315	1,286	1,654	1,928	1,807	1,110	842
Household operations	260	304	206	541	339	200	500	282	186
House furnishings and equipment	711	919	892	818	996	913	963	390	425
Apparel and services	935	1,158	915	922	1,344	1,482	1,403	838	588
Transportation	3,454	4,387	3,602	3,884	4,535	6,005	5,081	1,930	2,182
Vehicles	1,174	1,501	1,157	1,436	1,572	2,169	1,603	569	739
Gasoline and motor oil	1,175	1,512	1,224	1,314	1,625	2,016	1,778	703	704
Other vehicle expenses	880	1,125	945	998	1,138	1,500	1,371	494	544
Public transportation	225	249	276	135	201	320	329	165	193

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Health care	746	941	1,032	676	862	1,041	996	353	493
Entertainment	762	958	770	799	1,211	1,059	1,038	469	490
Personal care	158	197	189	118	194	267	228	100	103
Reading	117	141	136	127	149	153	131	65	87
Education	219	275	121	62	344	677	270	142	140
Tobacco	175	210	171	183	220	265	289	147	121
Miscellaneous	259	319	240	285	308	391	651	168	177
Cash contributions	501	623	649	282	574	934	563	186	353
Personal insurance and pensions	1,264	1,703	1,351	1,581	1,925	2,196	1,802	604	658

[1] Income values are derived from "complete income reporters" only.

Source: U.S. Department of Labor. Bureau of Labor Statistics. Consumer Expenditure Survey: Results from the 1980–81 interview. Washington 1984. P. 4, 9.

TABLE 5.—DISTRIBUTIONAL EFFECT BY FAMILY COMPOSITION OF VALUE-ADDED TAXES WITH EQUAL REVENUE YIELDS

[Revenue equal to a 5-percent VAT on all consumer expenditures or 4.3 percent of income]

1—Family composition (complete reporting of income)	2—VAT on all consumer expenditures (VAT rate = 5.0)		3—VAT on all consumer expenditures except food (VAT rate = 6.155)		4—VAT on all consumer expenditures except food, shelter-owned dwellings, shelter-rented dwellings, and health care (VAT rate = 8.079)		5—VAT on all consumer expenditures except items in column 4 and fuels, utilities, public services, and tobacco (VAT rate = 9.347)		5—VAT on all consumer expenditures except items in column 5 and public transportation and education (VAT rate = 9.817)	
	2a[1]	2b[2]	3a[1]	3b[2]	4a[1]	4b[2]	5a[1]	5b[2]	6a[1]	6b[2]
All family units	85.8	4.3	69.7	4.3	53.1	4.3	45.9	4.3	43.7	4.3
Husband and wife families:										
Total	82.0	4.1	66.6	4.1	51.6	4.2	44.8	4.2	42.8	4.2
Husband and wife only	79.9	4.0	65.9	4.1	49.9	4.0	43.3	4.0	41.5	4.1
With children:										
Oldest under 6	84.9	4.2	70.4	4.3	51.6	4.2	44.9	4.2	44.0	4.3
Oldest 6 to 17	84.3	4.2	67.9	4.2	52.4	4.2	45.5	4.3	43.5	4.3
Oldest 18 or over	79.0	3.9	63.3	3.9	52.0	4.2	45.4	4.2	42.4	4.2
Other	84.2	4.2	67.4	4.1	53.8	4.3	46.4	4.3	44.3	4.3
1 parent, at least 1 child under 18	108.8	5.4	84.0	5.2	60.0	4.8	48.7	4.6	45.9	4.5
Single persons and other families	94.3	4.7	77.0	4.7	56.3	4.5	48.3	4.5	45.5	4.5

[1] VAT base as percent of income.

[2] VAT yield as percent of income.

Source: CRS calculations based on data in: U.S. Department of Labor. Bureau of Labor Statistics. Consumer Expenditure Survey: Results from 1980–81 Interview. Washington, 1984. p. 4, 9.

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Families without both the husband and wife paid higher percentages of their incomes in VAT. Families with one parent and at least one child under 18 paid an average of 5.4 percent of their incomes in VAT. Single person families and other families paid an average of 4.7 percent of their incomes in VAT. Yet it can be argued that the range in the percentage of income paid in VAT is not large among families with different compositions.

An examination of the data in columns 3b, 4b, 5b, and 6b indicates that, as more items are zero rated, the variation in the percentage of income paid in VAT declines for families with different compositions. Column 6b shows that the VAT with the narrowest base absorbs an almost equal percentage of family income regardless of family composition. The range in the percentage of family income paid in VAT according to family composition is from 4.1 percent to 4.5 percent.

Therefore, selectively zero rating items can almost equalize the percent of income paid in VAT for families with different compositions. But, families with different compositions require different levels of income to achieve a given standard of living. For example, husband and wife families require more after tax income to achieve a given standard of living then do single person families. Yet no current estimates are available regarding the relative cost of living by family composition. Hense, it is not possible to determine if the regressivity of the VAT is reduced (or increased) by lessening the variation in the percent of income paid in VAT for families with different compositions. Nevertheless, policy makers may be interested in the distributional effects of zero rating different products on families with different compositions.

V. Summary and Conclusions

The large unified budget deficits forecast for fiscal year 1986 and future fiscal years have raised congressional concern about their possible harmful macroeconomic effects. Consequently, a value-added tax at the Federal level has been proposed as a major revenue source to reduce projected deficits.

The value added of a firm is the difference between the firm's sales and a firm's purchases for all other firms. A value-added tax would be levied at all levels of production as some percentage of each firm's value added.

A concern with any tax when tax liability is compared to ability to pay taxes is its vertical equity which concerns the tax treatment of unequals. This report uses annual family income as a measure of ability-to-pay taxes and the benchmark for equals or unquals.

The recently released results of the 1980–81 Consumer Expenditure Survey undertaken by the Bureau of Labor Statistics were used to measure the vertical equality of a VAT. These data show that a VAT covering all family expenditures would be regressive since, as family income rises, the percentage of family income paid in VAT would decline. The best distributional or vertical equity of a particular tax is a value judgment, but many people may be concerned about the regressivity of the VAT. Three methods that can be used to reduce the regressivity of the VAT are income tax cred-

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its, the partial linkage of revenues to social spending, and selectively excluding (zero rating) items from taxation.

Data show that selectively zero rating items can substantially reduce the burden of a VAT on the poor, but even a narrow-based VAT has pronounced regressivity. Also, selectively zero rating items can reduce the variability of the percentage of income paid in VAT of families with different compositions. But the effect of this reduced variability on the regressivity of the VAT could not be determined from the available data.

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